

# **Practice, practitioners, and praxis of audit committees in South African local government: A case study**

by

**Mariaan Roos**



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**Promotor:** Prof Johan Burger

**Co-Promotor:** Dr Len Mortimer

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## DECLARATION

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## ABSTRACT

Local government in South Africa faces many challenges including negative audit outcomes, reported corruption, weak financial and performance management, and lack of legal compliance. Through research, audit committees have been recognised as an important part of governance. The purpose of this study was to analyse what practices, practitioners, and praxis are associated with effective audit committees in local government.

A qualitative approach using the case research method and incorporating my story and experience (autoethnography) was followed. Data for the empirical research and analysis was obtained through in-depth, semi-structured interviews with 29 stakeholders affected by the audit committees at seven municipalities, publicly available and internally generated documents. A hybrid of agency, resource dependence, institutional and practice-orientated theories formed the basis in development and identification of determinants of effectiveness.

The results demonstrated that audit committees added value as a result of their composition, being independent with the necessary mix of skills and experience, and through their characteristics, including demonstrating a strong personal influence through interrogation and challenging context-based questions in a constructive manner. In addition, the display of honesty and objectivity, diligence, not being easily influenced, and demonstrating leadership is considered to be important. The value added is, however, dependent on the authority, resources, and support provided to the audit committee and the relationships between the different governance role-players. The most significant and pervasive challenge identified is the difficulty in attracting the required skilled and experienced members to serve on the audit committees, especially at rural municipalities.

In conclusion, audit committees contribute to governance and add value to municipalities despite some gaps between expectations, legislative requirements, and best practices and the practice, practitioners, and praxis of audit committees in the cases.

### Keywords:

Corporate governance; audit committee effectiveness; local government; practice, practitioners and praxis.

## OPSOMMING

Plaaslike regering in Suid-Afrika staan verskeie uitdagings, insluitend negatiewe oudit resultate, korrupsie, swak finansiële en prestasie bestuur en gebrek aan nakoming van wetlike vereistes in die gesig. Navorsing toon aan dat ouditkomitees 'n belangrike deel vorm van korporatiewe bestuur. Die doel van die studie was om te analiseer watter praktyke, praktisyns en praxis word geassosieer met effektiewe oudit komitees in die plaaslike regering.

'n Kwalitatiewe benadering is gevolg deur gebruik te maak van die gevalle studie metode terwyl my eie storie (outoetnografie) deurentyd in die proefskrif geïnkorporeer is. Data vir die empiriese navorsing en analise is verkry deur in-diepte, semi-gestruktureerde onderhoude met 29 belanghebbendes by sewe munisipaliteite wat geïmponeer word of kontak het met die ouditkomitee. 'n Hibriede van agentskap teorie, hulpbronnafhanklikheid teorie, institusionele teorie en praktykgerigte teorie vorm die basis van die ontwikkeling en identifisering van die determinante van effektiwiteit.

Die resultate van die studie wys dat die ouditkomitee waarde toevoeg as gevolg van die samestelling, die onafhanklikheid en die nodige verskeidenheid van vaardighede en ondervinding waaroor ouditkomitee lede beskik. Waarde toegevoeg word ook bepaal deur karakter eienskappe, insluitend die sterk persoonlike invloed deur ondervraging en uitdagende konteks gebaseerde vrae wat gestel word op 'n konstruktiewe manier. Die vertoning van eerlikheid, onafhanklikheid, ywer, nie geredelik beïnvloedbaar en leierskap van ouditkomiteelede word ook deur belanghebbendes geag om baie belangrik te wees vir effektiewe ouditkomitees. Waarde toegevoeg is egter afhanklik van gesag, hulpronne en ondersteuning aan ouditkomitee lede en die verhouding tussen die verskillende korporatiewe bestuur rolspelers. Die mees beduidende en deurdringende uitdaging is om ouditkomitee lede wat oor die nodige bekwaamhede en ondervinding beskik na munisipaliteite, veral die in plaaslike gebiede te lok.

Ter afsluiting, oudit komitees dra by tot bestuur en voeg waarde toe tot munisipaliteite ten spyte van sommige gapings tussen die verwagtinge, wetlike vereistes, beste praktyke en die praktyke, praktisyns en praxis van die ouditkomitees in die gevalle studies.

Sleutel woorde:

Korporatiewe bestuur; oudit komitee effektiwiteit; plaaslike owerheid, munisipaliteite, praktyke, praktisyns en praxis.



## ISISHWANKATHELO (ABSTRACT ISIXHOSA)

Urhulumente wasekhaya eMzantsi Afrika ujongene nemiceli mngeni emininzi kubandakanya neziphumo ezibi zokuphicothwa kwezemali, urhwaphilizo, ukungabi namandla kwemali kunye nolawulo nsebenzo, nokusilela kokuthobela umthetho. Ngophando, iikomiti zophicotho-zincwadi ziye zamkelwa njengenxalenye ebalulekileyo yolawulo. Injongo yolu phononongo yayikukuhlalutya iinkqubo, iingcali, kunye ne-praxis, (gabula bukhumsha), ezinxulumana neekomiti ezisebenzayo zophicotho kurhulumente wasekhaya.

Kwalandelwa inkqubo esemgangathweni kusetyenziswa indlela yophando kunye nokufaka ibali kunye namava am (i-autoethnography, ngokwesilungu). Idatha yophando olwenziwayo kunye nohlalutyo ifunyenwe kudliwano-ndlebe olunzulu, nolwenziwe ngendlela eyiyo kunye nabathathi-nxaxheba abangama-29 abachatshazelwe ziikomiti zophicotho-zincwadi koomasipala abasixhenxe, amaxwebhu afumaneka esidlangalaleni nangaphakathi. I-hybrid ye-arhente, ukuxhomekeka kubutyebi, iithiyori zeziko kunye nokuzilolongela ezenziweyo zenza isiseko kuphuhliso nasekuchongeni umiselo lwentsebenzo.

Iziphumo zabonisa ukuba iikomiti zophicotho-zincwadi zongeze ixabiso ngenxa yokuqulunqwa kwazo, ukuzimela ngokudityaniswa kwezakhono kunye namava, nangokweempawu zabo, kubandakanya ukubonisa impembelelo eyomeleleyo yomntu ngokubuza imibuzo kunye nemibuzo esekwe kumxholo ngendlela eyakhayo. Ukongeza, ukubonakalisa ukuthembeka kunye nokungathathi cala, ukukhuthala, ukungaphenjelelwa ngokulula, kunye nokubonisa ubunkokheli kujongwa njengokubalulekileyo. Ixabiso elongeziweyo, nangona kunjalo, lixhomekeke kwigunya, oovimba, kunye nenkxaso enikwa kwikomiti yokuphicothwa kweencwadi kunye nobudlelwane phakathi kwabathathi-nxaxheba abahlukeneyo. Owona mceli mngeni, ubalulekileyo ufumanekayo, bubunzima ekutsaleni amalungu afunekayo anobuchule kwaye anamava ukuba asebenze kwiikomiti zokuphicotho zincwadi, ngakumbi koomasipala basemaphandleni.

Ukuqukumbela, iikomiti zophicotho-zincwadi zinegalelo kulawulo kwaye zongeza ixabiso koomasipala nangona kukho ezinye izithuba phakathi kokulindelweyo, iimfuno zomthetho, nezona ndlela zibalaseleyo zenkqubeko futhi zisebenzayo, iingcali, kunye ne-praxis yeekomiti zophicotho zincwadi.

Amagama aphambili:

Ulawulo lokuzimela; ukusebenza ngempumelelo kwekomiti; urhulumente wasekhaya; ukuziqhelanisa, iingcali kunye ne-praxis.

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## LIST OF ACRONYMS

AC	Audit Committee
ACC	Audit Committee Chairperson
AFS	Annual Financial Statements
AGA	Association of Government Accountants
AGSA	Auditor-General of South Africa
AICPA	American Institute of Certified Public Accountants.
APR	Annual Performance Report
AR	Annual Report
BRC	Blue Ribbon Committee
CAE	Chief Audit Executive
CFO	Chief Financial Officer
CG	Corporate Governance
CIPFA	Chartered Institute of Public Finance and Accountancy
CoGTA	Department of Cooperative Governance and Traditional Affairs
COSO	Committee of Sponsoring Organisations of the Treadway Commission
CPD	Continuous Professional Development
DPME	Department Planning, Monitoring and Evaluation
EA	External Audit
EM	Earnings management
FS	Financial Statements
GFOA	Government Finance Officers Association
GRAP	Generally Recognised Accounting Practice
IAF	Internal Audit Function
IC	Internal Control
IDP	Integrated Development Plan
IIA	Institute of Internal Auditors
IFAC	International Federation of Accountants
IODSA	Institute of Directors Southern Africa
ISPPIA	International Standards for the Professional Practice of Internal Auditing
IT	Information Technology
LG	Local Government
MAYCO	Mayoral Committee
MFMA	Municipal Finance Management Act
MM	Municipal Manager
MPAC	Municipal Public Accounts Committee

MSCOA	Municipal Standard Chart of Accounts
MTSF	Medium Term Strategic Framework
NACD	National Association of Corporate Directors
PM	Performance Management
PS	Public Sector
PT	Provincial Treasury
PI	Performance Information
RM	Risk Management
SALGA	South African Local Government Association
SDBIP	Service Delivery and Budget Implementation Plan
SEC	Securities and Exchange Commission
SOX	Sarbanes-Oxley Act
UIFW	Unauthorised, Irregular, Fruitless and Wasteful Expenditure

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## CHAPTER ONE: INTRODUCTION AND STUDY LAY-OUT

### 1.1 Introduction

Governance and accountability, together with governing boards, including audit committees (ACs), have become the focus of substantial attention, interest, and criticism in the past few decades (Beasley, Carcello, & Hermanson, 1999:4; DeZoort, Hermanson, Archambeault, & Reed, 2002:38; Magrane & Malthus, 2010:427; Marx, 2008:1; Mustafa, 2003:25; Van der Nest, 2006:142). This increased focus can be attributed to many factors, including the demonstrated link between governance, boards, and their effect on performance and success, including service delivery issues (Renz, 2010:125,134), and the emphasis on full and fair public disclosure of corporate information (National Commission on Fraudulent Financial Reporting, 1987:5, also referred to as the Treadway Commission report). Global scandals, including fraud, the abuse of power, governance failures, and the evasion of accountability are other factors (Iskander & Chamlou, 2000:1; Jeavons, 2010:178; Marx, 2008:1; and Weiss, 2005:23). The Treadway Commission report identified audit committees as an important corporate governance pillar and suggested a list of objectives for audit committees to consider (DeZoort, 1997:212). Stakeholders, including management, auditors, and audit committee members, consider audit committees, in all spheres of government, to play a key role in the governance process (Braiotta, 2004: xv; Magrane & Malthus, 2010:427).

Local government operates within a complex environment (Governmental Accounting Standards Board, 2013:13, 33). Local government must balance fiscal, geographical, and demographic challenges and simultaneously address the demands of their political, regulatory, citizen, and business stakeholders (Chartered Global Management Accountant, 2014:2). Purcell agrees, indicating that local government is fully accountable for the resources of the community in terms of propriety, probity, legality, financial diligence, efficiency, and effectiveness according to societal norms and expectations (Purcell, 2012:3). The environment in which local government operates is also changing rapidly, with municipalities striving to manage costs while new infrastructure needs to be built in an environmentally sustainable manner, relationships with all the key stakeholders need to be maintained, communication with citizens needs to be enhanced, and the needs of the private sector business need to be considered (Chartered Global Management Accountant, 2014:10).

In South Africa, municipalities form an essential part of the economy, with 278 municipalities utilising a total budget of R378 billion in 2015-2016, R310 billion for operating expenditure, and R68 billion for capital expenditure (Auditor-General of South Africa (AGSA), 2017:26, 27). Local government is constitutionally empowered as an autonomous sphere of government responsible for service delivery to the people. A municipality has the right to govern the local government affairs of its community. The 278 municipalities in South Africa comprise of eight metropolitan, 44 district, and 226 local municipalities. The municipalities are focused on growing local economies and providing infrastructure and service (South African Government, 2019).

The leading corporate governance guideline document in South Africa, the King IV Report on Corporate Governance, recognises the importance of governance at local government level in the following statement:

“Good governance is essential to ensure the success of the municipality itself, and to protect and advance the interests of those whom it serves” (Institute of Directors Southern Africa (IODSA), 2016:79).

The Medium-Term Strategic Framework (MTSF), government’s strategic plan for the 2014-2019 period, defines the overall outcome for local government in outcome 9 to be a 'responsive, accountable, effective and efficient developmental local government system' (Department Planning, Monitoring and Evaluation (DPME): Medium Term Strategic Framework, 2014-2019, Appendix 9:1). The MTSF (DPME, 2014) states that municipalities operate in a complex environment and that many challenges, from an individual, institutional, environmental, and macro-socio-economic perspective, impact municipal performance. Some of the challenges identified in the MTSF relevant to this research include corruption at all levels with no consequences (related to institutional capacity); weak financial management and low budget spend; lack of oversight and accountability; lack of legal compliance or regulatory support; and weak municipal systems. From the enabling environment point of view, challenges include the financial viability of municipalities; the need to review the local government financing system; inconsistent, incoherent, and complex local government legislative environment and lack of customised support to municipalities, and lack of support focussing on compliance. With reference to the macro-level socio-economic context, challenges include weak public participation and a weak revenue base of municipalities with low levels of affordability (Department Planning, Monitoring and Evaluation: Medium Term Strategic Framework, 2014-2019, Appendix 9:2). The Auditor General of South Africa (AGSA) in the 2014-15 consolidated general report on the audit outcomes of local government, reported underperformance of municipalities in comparison to MTSF targets. Ten percent

(10%) of municipalities had adverse or disclaimed audit opinions (target 0%); 28% of municipalities had a qualified audit opinion (target 25%) and 59% had unqualified audit opinions against the target of at least 75% by 2019 (AGSA, 2016:16).

In the National Development Plan (National Planning Commission, 2011:364), the National Planning Commission identified the uneven performance in national, provincial, and local government due to various factors, including the erosion of accountability and authority.

Challenges in local government identified by other role players, such as National Treasury, include a lack of knowledge or disregard for legislation and processes by councillors and officials, and a lack of capacity and inability or disregard by municipalities to establish and maintain appropriate control systems (National Treasury, 2012:1). In response to the outcome of being a responsive, accountable, effective, and efficient developmental local government system, the then Minister of Cooperative Governance and Traditional Affairs (CoGTA) launched the back-to-basics approach in September 2014 to support the MTSF outcomes. The back-to-basics approach includes five key performance areas of which the following two are relevant for this study: ensuring sound financial management and accounting and prudent management of resources; and being well-governed and demonstrating good governance and administration. The approach recognises that good governance is at the heart of the effective functioning of municipalities and describes the basics of good governance to include the holding of council meetings, as legislated, the functionality of oversight structures, s79 committees,<sup>1</sup> audit committees and district inter-governmental relations forums, progress following interventions, the existence and efficiency of anti-corruption measures, compliance with legislation and the enforcement of bylaws, and the rate of service delivery protests and approaches to address them (CoGTA, n.d.: 7,10).

The local government MTSF chapter and the back-to-basic approach document indicate that the state of financial governance and management shows that much still needs to be done. Although the legislative framework to establish institutions of local government has been in place for more than 10 years, the implementation needs to be accelerated to ensure municipalities fulfil their developmental mandate (DPME, 2014:12).

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<sup>1</sup> S79 committees refer to committees appointed by Council to assist with the performance of any of the Council functions in accordance with the requirements of the Municipal Structures Act 117 of 1998, section 79 (RSA, 1998).



The challenges experienced in local government and the need for improved governance have been raised by various role-players at different forums and platforms and reflected on in the introduction. The next section further elaborates on the challenges, specifically related to the topic of the research, and the role of the audit committee as part of the governance structure.

## 1.2 Background to the research problem

In South Africa, the audit outcomes as reflected in the Auditor-General general reports on local government for the past six years (2011/12 - 2016/17) depict significant problems and Table 1.1 provides a summary of the key AGSA findings during these years. Figure 1.1 depicts a performance snapshot reported by the AGSA comparing the outcomes and key findings between the 2015/16 and 2016/17 financial years. From Figure 1.1, it is evident that overall, the audit outcomes regressed, the financial statements and performance reports submitted to the AGSA for audit purposes were not credible and the extent of irregular expenditure increased by more than R10 billion. The key message expressed by the AGSA was ‘that we can take from the 2016-17 audits is that accountability continues to fail in local government (AGSA, 2018:2). Extracts from the 2016/17 general report on local government outcomes are depicted in Figure 1.1.

The status of controls, one of the key oversight areas of the AC, as well as assurance provided by assurance providers have also regressed and is reflected by extracts from the AGSA Report as summarised in Figure 1.2. From Figure 1.2, it is evident that between the 2015/16 and 2016/17 financial year basic financial and performance management controls, a key oversight responsibility area of audit committees, have regressed. The Auditor-General concluded: “The recommendations we made last year to improve audit outcomes and accountability did not receive the necessary attention. This is evidenced by the findings from our audits that included attention not being paid to audit action plans, poor performance planning and budgeting (resulting in unauthorised expenditure of R12,6 billion), and regressions of varying degree in the status of internal control and the assurance provided by the different role players in local government” (AGSA, 2018:2).

Some of the commentary made by the Auditor-General on the significance of the problem includes:

“Credible financial statements and performance reports are crucial to enable accountability and transparency, but municipalities are failing in these areas. Not only did the unqualified

opinions on the financial statements decrease from 68% to 61%, but the financial statements provided to us for auditing were even worse than in the previous year... The recommendation we made last year to improve audit outcomes and accountability did not receive the necessary attention. This is evidenced by the findings from our audits that include attention not being paid to audit action plans, poor performance planning and budgeting ..., and regressions of varying degree in the status of internal control and the assurance provided by the different role players in local government" (AGSA, 2018:2).

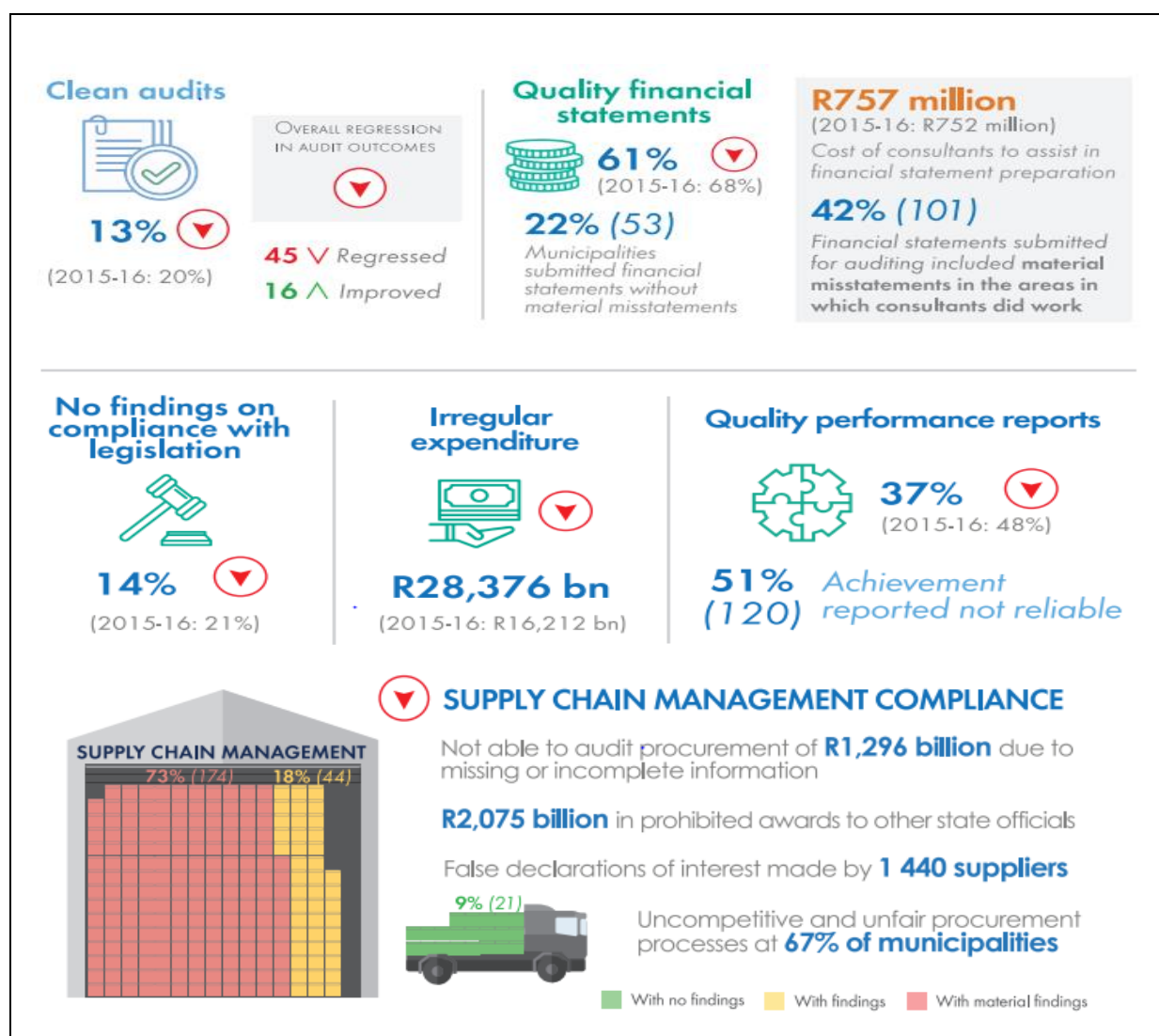


Figure 1.1. Extracts from the 2016/17 Consolidated General Report on local government audit outcomes (AGSA, 2018).



**Figure 1.2. Extracts from the 2016/17 Consolidated General Report on status of internal controls and assurance providers (AGSA, 2018).**

Furthermore:

The poor quality of financial statements submitted to us for audit and the continuing reliance on consultants for financial reporting services call into question whether in-year reporting and management of finances by municipalities are solid. Signs of **poor financial management** are apparent in the budget preparation and monitoring processes (resulting in unauthorised expenditure) and the financial viability of municipalities, which continues to weaken year on year” (AGSA, 2016:17).

‘The root causes of the weaknesses in financial and performance management and the poor audit outcomes are as follows:

“Management (accounting officers and senior management), the political leadership (mayors and councils), as well as oversight – municipal public accounts committees (MPACs) and portfolio committees – do not respond with the required urgency to our consistent messages about addressing risks and improving internal controls. There has been some improvement in the control environment of municipalities over the past five years, but progress has been slow

and in 2014-15 we rated the majority of municipalities' status in all areas of control as either 'concerning' or 'intervention required' (AGSA, 2016:17-18).

A similar conclusion was reached by the Auditor-General on the 2015-16 audit outcomes: "The key drivers of **internal control** being leadership, financial and performance management as well as governance, had shown minimal improvement since the previous year. This slow response by the leadership to our consistent messages over the years to improve internal controls and address risks, was the main **root cause of poor audit outcomes**" (AGSA, 2017:10).

The audit opinions on the financial statements improved slightly from 60% to 62% unqualified in 2015-16. The quality of performance reports with no material findings increased from 38% to 47%, indicating almost half of the municipalities had challenges in reporting reliable performance information and a regression in compliance with key legislation, with the number of municipalities with no material findings decreasing from 20% to 18% (AGSA, 2017:11).

Table 1.1 reflects some of the key findings in the audit outcomes between 2011/12 and 2016/17.

The South African Local Government Association (SALGA) also questioned the contribution made and effectiveness of audit committees, as part of governance (SALGA, 2013).

In the 2011-12 audit report the Auditor-General indicated that key role players, including internal audit personnel, audit committees, treasury, cooperative governance departments and the premier's office, needed to take some vital actions to ensure improved results. The success of audit committees in fulfilling their oversight responsibility depends essentially on a working relationship with the other participants of corporate governance (AGSA, 2013:12).

For the 2012-13 year the Auditor-General stated that the assurance provided by internal audit units, audit committees, treasuries, departments of cooperative governance and offices of the premier was also not at the required level (only 22%), and these role players still did not make a positive and sustainable contribution. The assurance provided by internal audit units and the audit committee was higher than that of the other role players, but they were not yet effective in providing internal assurance and oversight. 'There was insufficient focus on the reliability of performance information and evaluation of IT controls and compliance' (AGSA, 2014:29).

**Table 1.1: Summary of key Auditor-General findings on local government between 2011/12 and 2016/17**

	<b>Performance Reports</b>	<b>Audit opinion</b>	<b>Legislative compliance</b>	<b>Unethical conduct</b>	<b>Internal Control</b>	<b>Assurance providers</b>
<b>2011/12</b> <sup>2</sup>	Annual performance reports not useful and/or reliable.	25% of auditees received disclaimed or adverse opinions and 21% qualified opinions.	At 94% of auditees there was material non-compliance with legislation.	Contracts to the value of at least R118 million awarded to municipal officials and councillors.	Confidentiality integrity and availability of information at risk.	Key role players did not provide assurance to improve controls and address risk areas and root causes.
<b>2012/13</b> <sup>3</sup>	Reduction in auditees with findings on their annual performance reports.	20% of auditees received disclaimed or adverse opinions and 25% qualified opinions.	At 90% of auditees there was material non-compliance with legislation.	Uncompetitive and unfair procurement processes, inadequate contract management and missing tender documentation.	Only slight improvement in the drivers of internal control.	No increase in the required level of assurance provided by assurance providers.
<b>2013/14</b> <sup>4</sup>	Steady improvement in quality of performance reports.	17% of auditees received disclaimed or adverse opinions and 22% qualified opinions.	Non-compliance with key legislation remains at high levels but is improving.	Non-compliance resulting from uncompetitive or unfair procurement processes at 69% of auditees contributing to high levels of irregular and fruitless and wasteful expenditure.	Internal control is improving but basic controls and disciplines require attention. Information Technology (IT) controls continue to need attention.	All role-players should increase the level of assurance provided.
<b>2014/15</b> <sup>5</sup>	62% of municipalities with material findings on annual performance reports.	11% of auditees received disclaimed or adverse opinions and 28% qualified opinions.	78% of municipalities with material findings on compliance.	Number of municipalities with Supply Chain Management findings has remained at the same level since 2011-12.	Lack of response to consistent messages about addressing risks and improving internal controls. Status of IT controls of particular concern.	Management political leadership and Municipal accounts committees and portfolio committees not adequately addressing risks and improving internal controls.
<b>2015/16</b> <sup>6</sup>	62% of municipalities with material findings on annual performance reports.	10% of auditees received disclaimed or adverse opinions and 28% qualified opinions.	At 82% of auditees there was material non-compliance with legislation.	Weakening in Supply Chain Management in areas of competitive bidding, contracts awarded to employees, councillors, families, and other state officials.	Poor and non-compliant consequence management.	Assurance provided by senior management, mayors, councils and MPAC remained at low levels and those of municipal managers regressed.
<b>2016/17</b> <sup>7</sup>	62% of performance reports with material flaws and not credible for council and public use.	Only 22% of municipalities provided financial statements free of material misstatement.	At 86% of auditees there was material non-compliance with legislation.	At 73% material findings in supply chain management.	Regression in overall internal control to 22%.	Overall regression in assurance provided by different role-players.

For the 2013-14 year the Auditor-General concluded that the assurance provided by internal audit units and audit committees was higher than that of other role-players at 34% and 36% respectively but that they were not yet effective in providing internal assurance and oversight.

<sup>2</sup> AGSA (2013:2).

<sup>3</sup> AGSA (2014: 2-3, 85).

<sup>4</sup> AGSA (2015: ii-iii).

<sup>5</sup> AGSA (2016: 16-18).

<sup>6</sup> AGSA (2017: 11, 16-18).

<sup>7</sup> AGSA (2018: 2-3).

Specific areas where more attention was needed was on reliability of performance information and the evaluation of IT controls and compliance (AGSA, 2015:13).

For the 2015-16 year the Auditor-General concluded:

“The assurance provided by senior management, mayors, councils, and municipal public accounts committees (MPACs) remained at low levels and showed little improvement in the past year, while that of municipal managers regressed. Although internal audit units and audit committees had the highest assurance levels, little progress had been made in the past year and they had little impact on the audit outcomes at more than half of the municipalities” (AGSA, 2017:13).

Some of the challenges public sector audit committees face in South Africa are described in the guidance paper entitled *Challenges facing public sector audit committees* (IODSA, 2014a:7-9) and include:

- Public sector entities operate within a unique regulatory framework and the terms of reference of a public sector audit committee do not always clearly define the requirements of the audit committee in relation to the entity’s environment.
- Unclear accountability, role clarity, and reporting lines.
- The roles of the audit committees versus other committees, such as the finance committee, risk committee, municipal public accounts committee and performance committee, due to current legislation not specifying the roles of the other committees.
- Possible impairment of audit committee independence as a result of previous/current relationships between audit committee members or the audit committee as a whole and political standing and/or management.
- Difficulty in attracting a pool of suitable persons to serve on the public sector audit committee and related to this the remuneration of committee members and the political influence in the appointment process.
- Inadequate dedication and commitment by audit committee members evidenced by lack of preparation for meetings, lack of following-up on issues requiring attention and poor attendance and participation in meetings.
- Lack of support from management and receiving insufficient and poor quality of information to enable fulfilment of responsibilities.

This research focuses on audit committees in local government in South Africa. One of the few studies on audit committees in the public sector in South Africa by Van der Nest (2006:223) focused on national departments. He concluded that although audit committees in

most instances complied with best practice recommendations regarding meeting procedures, agenda items, and legislation, communication with management and the accounting officer was inadequate. The results of his research on the correlation between compliance with best practice and perceived effectiveness of audit committees indicated that mere compliance with legislation and best practice requirements were not directly associated with the perceived effectiveness of audit committees.

Marx (2008:2), in his study on effectiveness of audit committees at large, listed companies in South Africa, quoted the challenges to audit committees from various sources including increased workload, establishing a strong working relationship with management and auditors, having adequate time to fulfil their responsibilities, concerns about personal liability, and maintaining a balance between oversight and advice to management without micromanaging. He concludes on the limitations and threats to audit committee effectiveness as follows (Marx, 2008:59):

“...it is evident that the modern audit committee faces many challenges, threats and limitations that might, if not properly addressed, impact negatively on the effectiveness of audit committees and the value it can bring to an entity’s governance structures. A clear understanding by the audit committee of such limitations is essential and, accordingly, active steps should be taken to address these limitations.”

Although Marx’s (2008:23) study focuses on the private sector, similar challenges are experienced by audit committees in local government. He recognises the findings of his study can also add value to audit committees in the public sector.

The criticism against the effectiveness of audit committees is not limited to South Africa and the statements by the Auditor-General in South Africa (AGSA). The audit committee forms a key component of governance and various studies on the effectiveness and challenges audit committees face have been completed and are further elaborated on in the literature review chapter. The following widely quoted comment by Arthur Levitt, the chairman of the U.S. Securities and Exchange Commission (SEC), and now chairman emeritus, with respect to audit committees confirms this:

“...qualified, committed, independent and toughminded audit committees represent the most reliable guardians of the public interest. Sadly, stories abound of audit committees whose members lack expertise in the basic principles of financial reporting as well as the mandate to ask probing questions ...” (U.S. Securities and Exchange Commission, 1998).



The following statement by Turley and Zaman (2004:321) confirms:

“The fact that corporate failures and irregularities occur in companies with audit committees with audit committee complying with, or even exceeding, recommended best practice illustrates the importance of understanding the process associated with audit committee operations .... This conclusion indicates that the character and operations of audit committee may be fruitful areas for research into the conditions under which anticipated benefits of audit committees can be realised.”

Bronson, Carcello, Hollingsworth and Neal (2009:265) also refer to concerns about financial reporting quality and frequent accounting scandals leading to the questioning of the effectiveness of audit committees as a key governance mechanism.

A detailed review of academic research literature and reflection in Chapter 2 revealed that audit committees have been studied over the past decades to gain insight into a variety of topics.<sup>8</sup> However, most of the academic research focuses on audit committees in the corporate sector and limited research on audit committees in the public sector and in local government specifically has been completed. Hepworth and De Koning (2012:4) indicate that no international public or private sector standards for audit committees exist and most recommendations for public sector audit committees focus on the appointment of audit committees, their membership, and responsibilities. Wayne (2003:93), in recommendations on future research, identifies the need to obtain the viewpoints of role-players other than audit committee members themselves and to understand the nature of the audit committee and evaluate whether it is consistent with the regulatory mandate.

One of the few studies on effectiveness of audit committees in local government, completed in Australia, found that:

“The mayor and the chief executive have to carefully balance competing ‘needs’ and ‘wants’ of constituents, councillors, and stakeholders in equilibrium, with the need to manage the operations of council and deliver community service outcomes. This can have implications for the independent members of the audit committee in the diligent discharge of their duties” (Purcell, Francis & Clark, 2014:342).

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<sup>8</sup> Examples of some titles include: *Incentives for the Audit Committee to Signal their Monitoring Activities using Voluntary Disclosure in the Audit Committee Report* (Reidenbach, 2013); *The Influence of Individual Audit Committee Chairs, CEOs, and CFOs on Corporate Reporting and Operating Decisions* (Lawson, 2012); *Audit Committee and Auditor Ties: An Empirical Examination of Network Effects* (Scalan, 2011); and *Controlling Shareholders, Audit Committee Effectiveness and Earnings Quality: The Case of Thailand* (Kiatapiwat, 2010).



There is no doubt that the traditionally identified characteristics of effective audit committees, including independence and expertise, are extremely important for governance as evidenced by various studies (Bronson et al., 2009:267-268). Even though many rules and regulations require audit committees to be independent and have financial expertise and diligence, these characteristics do not necessarily guarantee high-quality decisions by the audit committee (Turley & Zaman, 2004:306). It is considered necessary to investigate additional contributing factors or characteristics, including the importance of stakeholder relations and their impact on the effectiveness of audit committees in a local government environment.

### **1.3 The stated research problem**

Local government in South Africa operates within a complex environment that is constantly changing with increasing demands on limited resources. Based on the findings and shortcomings in governance of local government identified by the Auditor-General over the past years and various other role-players, municipalities are not achieving the overall outcome identified in the MTSF to be responsive, accountable, effective, and efficient. Ensuring sound financial management and accounting, prudent management of resources, being well-governed, and demonstrating good governance and administration are areas that need attention to turn the situation around. The audit committee has a key role to play in good governance, contributing to the effective functioning of municipalities.

The research problem identified is that although the legislative framework to establish institutions of local government including audit committees have been in place for more than 10 years, negative audit outcomes, reported corruption, weak financial management, and lack of legal compliance indicate the governance and oversight at municipalities are not effective and performance by audit committees and other key role players might not be at the required level.

The roles and responsibilities of audit committees in the public sector and local government have expanded considerably over the last decade but accountability, role clarity, independence and skills requirements, dedication and commitment, and lack of support are some of the challenges experienced by audit committees in the public sector.

## 1.4 Research questions

Although having audit committees in local government is a legislative requirement in South Africa and has existed for many years, governance shortcomings indicate audit committees might not to be effective in fulfilling the oversight and advisory role expected of them.

From the preceding background and research problem, the primary research question is:

- What practice, practitioners, and praxis are associated with effective audit committees in local government?

The secondary questions are:

- How does the current composition of audit committees that include expertise and independence, impact on the effectiveness of audit committees?
- Are municipalities able to attract persons to serve on audit committees that have sufficient knowledge, skills, and experience in the required areas?<sup>9</sup>
- Do audit committees appear to provide substantive oversight or do they appear to be primarily ceremonial bodies designed to create legitimacy?
- Do audit committees have the necessary relationships, authority, and organisational support to ensure effective execution of their roles and responsibilities?
- How do audit committees demonstrate the effective performance of their roles and responsibilities?
- Is there a gap between what is required of audit committees in terms of legislation and best practice and the expectations of stakeholders?

The results of this research are of interest to the public and local communities, academics, legislators, and practitioners for several complementary reasons. Firstly, the research allows for insight into an area of municipal oversight in South Africa that has not been previously studied. In South Africa, limited research has been done on the effectiveness of audit committees in the government sector and Marx (2008:27), in his thesis on effectiveness of audit committees at large, listed companies' urge for more research to be conducted on South African audit committees in the government sector. Secondly, there is no empirical evidence to either confirm or refute the criteria of effectiveness for audit committees in local government.

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<sup>9</sup> According to the King III, the audit committee should collectively have an understanding of integrated reporting (including financial reporting), internal financial controls, the external and internal audit process, corporate law, risk management, sustainability issues, information technology governance and the governance processes in the organisation. Added to that is the public sector specific knowledge required about matters such as performance management and compliance with laws and regulations.

Finally, the research contributes to governmental governance literature in general with implication for public policy. This is of interest to policy makers because they are answerable for billions of taxpayers' money allocated to local government in South Africa.

Answers to the research questions will generate knowledge to create a framework that will improve the contribution by audit committees to corporate governance and inform solutions and recommendations for challenges experienced by audit committees in local government. The results of the study could also lead to suggestions for policy, processes, and structures for audit committees in local government, and a model for further use/replication to study similar research problems in other or related contexts.

## 1.5 Research objectives

The key research objective is to:

**determine what practice, practitioners, and praxis are associated with effective audit committees in local government, South Africa.**

Additional research objectives to enable achievement of the key research objective include: Firstly, a comprehensive literature review of academic research literature focussing on the theoretical framework and studies on audit committee effectiveness in the public sector and in local government specifically.

Secondly, to examine [corporate] governance and the specific part audit committees play in governance in the public sector and local government.

Thirdly, to obtain an understanding of the different roles and responsibilities of the audit committee in South African local government prescribed in legislation, corporate governance codes and guidance documents.

Fourthly, to research the determinants of effective audit committees in local government reflected in academic and professional literature and as perceived by other governance stakeholders.

Governance stakeholders, for this study, refer to the mayor, the municipal manager (MM), audit committee chairperson (ACC), chief financial officer (CFO), chief audit executive (CAE), and the external auditor (EA). Unfortunately, although external audit was initially identified as a stakeholder, it was not possible to secure discussions with representatives of AGSA. The final research objective was to investigate if there is a disjuncture between what is required of

audit committees in terms of legislation and best practice and the expectations of governance stakeholders. Achieving the objectives of the research enabled the researcher to identify the practice, practitioners and praxis associated with effective audit committees.

## 1.6 Methodology

The methodology comprises a comprehensive literature study that identifies and discusses critical aspects of audit committee effectiveness. The literature study provides the foundation for the aspects that were tested empirically. The research objectives were achieved by using the case study method. The case study comprises a combination of two district and five local municipalities in South Africa in two of the nine provinces. The approach used allowed the researcher to obtain a better understanding of the processes and behavioural effects over and above the formal legislative requirements and official policies that impact the effectiveness of audit committees. The case study method also allowed the researcher to take the specific context of the municipality into account. Chapter 6 elaborates on the methodology, including the appropriateness of the case study method for this research.

Data for the empirical research and analysis of the case study were gathered by way of a field research approach from primary and secondary sources including:

- In-depth, semi-structured interviews with 29 stakeholders affected by the audit committees including the mayor, the MM, the CFO, the CAE, and the chairperson of the audit committee. Interviewees were asked to describe characteristics of audit committees referring to the mandate and authority, composition and procedures, the activities of the audit committees and their perception of the effectiveness of the audit committees and the benefits to the organisation. All interviews, where consent was provided, were tape-recorded, and transcribed for analysis. The themes covered during the interviews were informed by legislative requirements, determinants used in other research on audit committees and good guidance documents.
- Prior to the in-depth interviews, discussions were held with the mayor, MM, CAE, and CFO at a pilot site to test the relevance, completeness, and clarity of interview themes and the approach.
- Publicly available information including annual reports, Auditor-General reports, audit committee reports and the websites of the municipalities.

- Internally generated documents made available. Documents include the audit committee charter; agendas of audit committee meetings, audit committee quarterly reports, minutes of audit committee meetings and audit committee reports to council.

The study is more descriptive than causal and considers the relationship between the effectiveness of the audit committee based on compliance with best practices, how the audit committee actually performs through formal and informal processes, and the stakeholders' perceptions of the effectiveness of the audit committees.

The study addresses the need identified and captured by Brennan & Kirwan recognising it is difficult to assess whether governance is a mere corporate ritual and whether the audit committees are genuinely active in executing their duties robustly through archival studies alone (2015:476). This points to a need for more practice-orientated studies that examine the practice, practitioners, and praxis of audit committees.

## 1.7 Own experience

A unique feature of this study is the sharing of personal knowledge and own experience informed by serving on audit committees, including acting as the ACC in the public sector for over 20 years. The researcher's own experience is intertwined throughout this study but is elevated by using the following symbol:



Flyvbjerg recognises the importance of own experiences:

"The highest level in the learning process, that is, virtuosity and true expertise, are reached only via a person's own experiences as practitioner of the relevant skills" (Flyvbjerg, 2011:303).

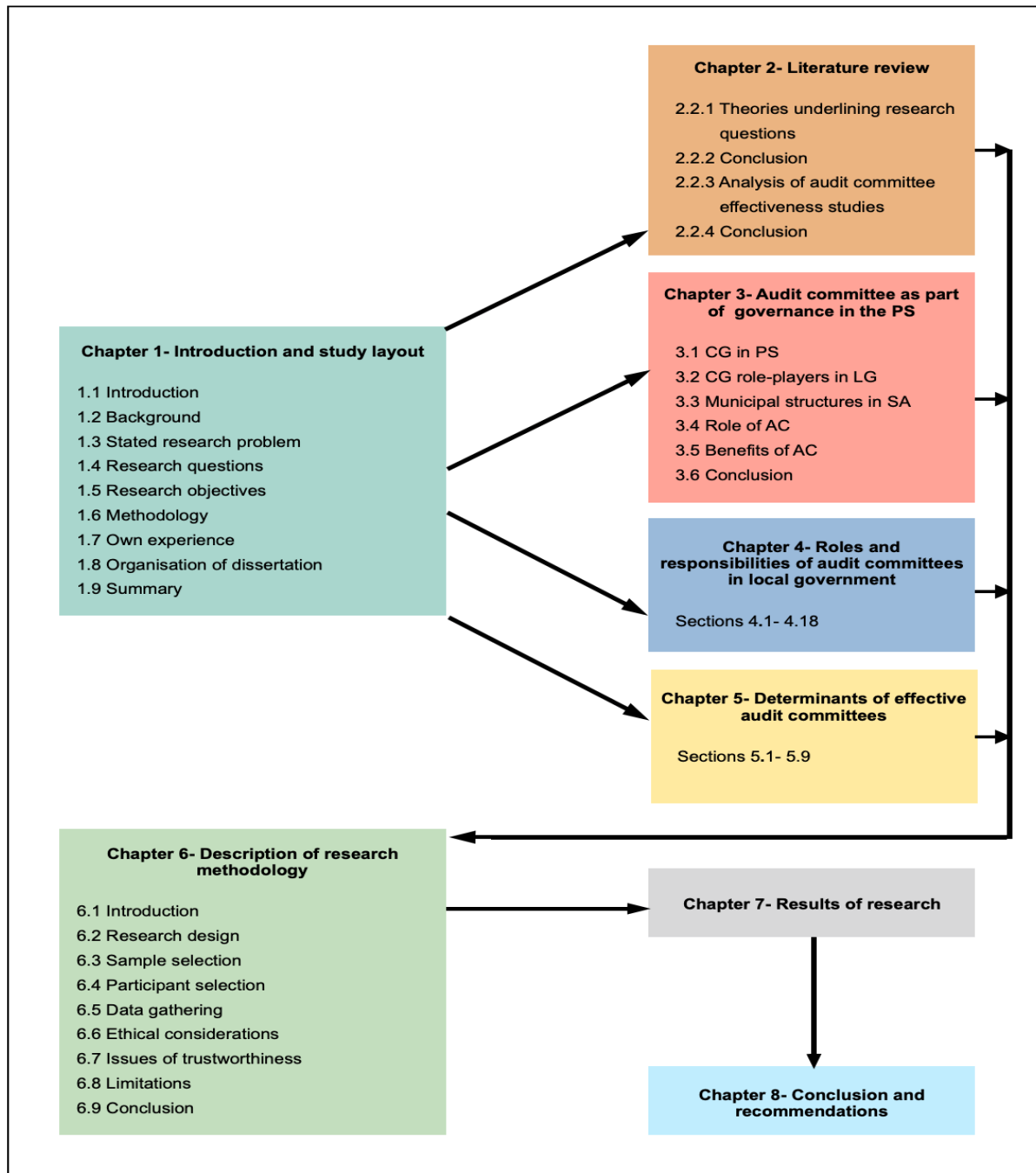
The sharing of own experiences, also referred to as autoethnography, is not new and various researchers, referred to in Chapter 6, have recognised the importance of sharing personal feelings and thoughts and being self-visible in the text. By living and sharing personal experiences the researcher believe she was able to gain additional in-depth insight and

expand on information on the effectiveness of audit committees which is shared as part of the research results. Through self-reflection, the researcher also had to confront her own strengths and weaknesses in serving on audit committees. Autoethnographic writing has also become increasingly common in different disciplines. The researcher also decided to share own experiences to create a more equitable relationship between herself and those that was studied by analysing the views and those of other audit committee members and affected parties. Through the exploration of the research topic and the research questions, together with own experiences, the researcher believe she was able to provide a more complete picture.

According to Flyvbjerg (2011:303), concrete context-dependent experiences can be achieved through studying reality and feed-back from those being studied, which was achieved during this research and presented in Chapter 7.

The next section provides an overview of the study and Figure 1.3 is a visual high-level representation of the thesis of the contents and the linkages between the various topics.

## 1.8 Organisation of dissertation



**Figure 1.3. Visual presentation of organisation of dissertation**

The study is divided into the following eight chapters.

*Chapter one* provides an introduction and background to the study and research problem. The research questions and research objectives of the study are articulated in this chapter together with a high-level explanation of the methodology followed. This chapter also explains how the own experience of the researcher incorporating elements of the autoethnography approach is presented in this research.

*Chapter two* presents the review of the literature on studies of audit committee effectiveness. Chapter 2 includes a section on the different theoretical bases used in the studies on audit committee effectiveness and its applicability to this study, followed by a section on the analysis of the studies on audit committee effectiveness. The theories explored include the agency theory, resource dependence theory, institutional theory, managerial hegemony theory, practice theory, and hybrids of different theories. For this study, a hybrid of agency, resource dependence, institutional, and practice theory is recommended, and Figure 2.3 in Chapter 2 summarises the motivation for this selection. The analysis of audit committee effectiveness studies is presented and discussed in Chapter 2, distinguishing between the categories of practice, practitioners, and praxis. Practices refer to the rules and procedures practitioners combine and adapt to their needs, while the context through the actual activities is referred to as praxis. Through these actual activities, theory and practice are combined with a view to change and improve practice.

*Chapter three* presents audit committees as part of governance in the public sector. The chapter starts by explaining the meaning of corporate governance and the evolution thereof as contained in the different corporate governance codes in South Africa. This is followed by a discussion of the principles and value of governance, including those in the public sector. The different governance role-players within the context of the municipal structure are presented focussing on the integral part audit committees play in the governance *eseke/we*<sup>10</sup>, demonstrating the link between governance principles and audit committee responsibilities. The chapter presents the role of the audit committee and the expansion thereof as well as the value added by audit committees.

*Chapter four* describes the extensive roles and responsibilities of audit committees focussing on local government audit committees in South Africa. Areas of responsibilities described in the chapter include review of financial reporting, work of internal audit, implemented internal control, risk management, external audit, combined assurance, performance management, compliance, IT governance, ethics, and fraud. The chapter also reflects on reporting by the audit committee to demonstrate the fulfilment of its roles. The chapter presents a brief overview of possible liability of the audit committee in the fulfilment of its roles and responsibilities.

*Chapter five* offers a discussion on various determinants of audit committee effectiveness used in academic research and in practice through professional literature. The chapter

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<sup>10</sup> Xhosa word for mosaic.



describes enabling factors including power and authority of and support to the audit committee. Audit committee experience and expertise, composition and independence, authority, resources, diligence and remuneration as contributing factors and indicators of effective audit committees are also presented. Characteristics of audit committee members and the chair are also included as part of the discussion. The audit committee charter providing power and authority is also considered as part of this chapter.

*Chapter six* describes the methodology used for this study. The research moves away from the traditional agency theory being used in most studies on audit committees by using a hybrid of theories including agency, resource dependence, institutional, and practice-orientated theory. The researcher made use of a qualitative approach, using the case study research method and shared her own experiences (autoethnography) throughout the study. The study used a variety of theoretical constructs, data sources, contexts, and samples to generate rich, thick, and multi-layered data.

*Chapter seven* describes the results of the empirical study and includes a summary and analysis of the research findings on the practices, practitioners, and praxis of audit committees in local government. The fieldwork focussed on the mandate and authority, composition and appointment, roles and responsibilities, formal and informal interactions, and audit committee communication including reporting. The research findings were informed by discussions with various stakeholders including the ACC, mayor or council representative, MM, CFO and CAE and analysis of publicly available municipal documentation and documentation provided during the fieldwork.

*Chapter eight* is the concluding chapter and presents the main findings of this research based on the literature review and the fieldwork. This chapter also demonstrates how the research questions were answered and what these answers mean. In conclusion, recommendations for consideration, the limitations of this study and possible future research areas are included.

## 1.9 Summary

Chapter 1 introduces this study by highlighting the need for governance, as well as the important governance role of the audit committee in the complex and challenging but important local government environment. The results of the Auditor-General's audit outcomes over six years together with criticism and challenges the audit committees face in fulfilling their responsibilities sketch the background to the research problem. The introduction and

background information supports the research problem and demonstrates the need for research to determine why, despite audit committees in local government being a legislative requirement in South Africa, governance shortcomings still exist. The objective of this study is to research the practice, practitioners, and praxis associated with effective audit committees in local government demonstrated by the performance of their roles and responsibilities and as perceived by stakeholders. The determinants of effectiveness used in the study include enabling factors, composition and independence, authority, resources and support, diligence and relationship with various role-players. How the audit committee demonstrates the fulfilment of their roles and responsibilities also formed part of the research.

This chapter provides a high-level overview of the methodology used that is elaborated on in Chapter 6. Further to the interviews and document analysis, through introspection, the researcher also shares personal knowledge, own experience, personal feelings, and thoughts, and acknowledges the strengths and weaknesses in the story of serving on audit committees. The study extends the work of other researchers in relation to audit committees and addresses the knowledge relating to the effectiveness of audit committees in the unique governance setting of selected municipalities in the Western and Northern Cape in South Africa. The culmination of this provides a unique opportunity to share and gain knowledge. This chapter concludes with a visual overview of the organisation of the study. The next chapter reflects on existing literature on audit committee effectiveness and more specifically audit committee effectiveness in local government.

## CHAPTER TWO: LITERATURE REVIEW OF EFFECTIVE AUDIT COMMITTEES

### 2.1 Introduction

This chapter provides a summary of the existing literature or existing scholarship, as referred to by Mouton (2009:87), on audit committee effectiveness, audit committee effectiveness in the public sector, and more specifically audit committee effectiveness in local government or municipalities. The literature review aims to reflect a scientific perspective on the research topic of practice, practitioners, and praxis in local government in South Africa. A review of academic research literature reveals that audit committees have been researched extensively but that most academic research focuses on audit committees in the corporate sector and limited research on audit committees in the public sector and in local government specifically has been completed (AGA, 2008:4; Purcell, 2012:59; Strickland, 2011:3). Annexure 1 provides an overview of postgraduate studies on audit committees, distinguishing between the private and public sector, and was compiled with the aim to avoid duplication of effort and conceptual or procedural problems.<sup>11</sup> Due to the limited research on public sector and local government audit committees, it was necessary to undertake a literature review on the general literature on audit committees and look for relevant linkages to local government audit committees.

The existing scholarship reviewed includes research on audit committees as part of the governance *eseke/we*; the roles and responsibilities of audit committees; studies on and determinants of effectiveness of audit committees; the theories used and hypotheses tested in research on audit committee effectiveness; and the empirical findings produced by the research. The literature review covers the above areas to inform the research on the practice, practitioners, and praxis of local government audit committees. This chapter provides a summary of the results of the literature review and additional relevant information resulting from the literature review is included in Chapters 3, 4, and 5.

Different types of literature reviews exist. According to Du Plooy-Cilliers, Davis, and Bezuidenhout (2014:102) literature reviews could include historical reviews – trace chronological order of the literature; thematic reviews – group literature in differing views or perspectives; theoretical reviews – consider theoretical developments and empirical reviews that focus on different methodologies used. Mouton (2009:92-95) differentiates between

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<sup>11</sup> The three goals of a good literature review have been identified by Dane (1990:62) as obtaining a scientific perspective, avoiding duplication of effort, and avoiding conceptual and procedural problems.

chronologically reviews – start with older studies and proceed until you end with the latest research; school of thought, theory, or definition – discuss the most relevant theories, models, or definitions of a particular phenomenon; theme or construct; hypothesis; case study – used where units of analysis are large groups; and method – focus on different methods used to investigate a specific phenomenon. The literature review chapter of this research reflects the results by using a combination of the theoretical/method and thematic types of literature review. Section 2.2.1 of Chapter 2 presents the literature from a theoretical point of view and section 2.2.3 from a thematic point of view. The literature review includes primary sources and secondary sources. The next section reviews prior literature on audit committees, summarising both the theories used and the results of the research on audit committee effectiveness.

## **2.2 Studies on audit committees and effectiveness**

The literature review includes both academic and professional research on the effectiveness or perceived effectiveness of audit committees. A review of academic research literature indicates that most of the academic research on governance and audit committees relate to the corporate (private) sector rather than government (West & Berman, 2003:330), which is also proven in research by Purcell (2012:15). This was confirmed by the need identified by the Association of Government Accountants (AGA) (2008:4) resulting in a commissioned study on the characteristics of effective audit committees in government including federal, state and local governments as a result of the limited research and information that was available on government audit committees.

It was further discovered that most of the studies and research focus on audit committees in the USA, including the pre-Sarbanes Oxley and the post-Sarbanes Oxley period. The extent of audit committee research in North America, specifically the USA, is also noted in the thesis of Purcell (2012:68) explaining the focus, which was as a result of the prescriptive corporate governance regime for the formation and continuity of audit committees versus voluntary regimes in other countries. The emphasis on audit committees in the USA became very prominent, after the Sarbanes Oxley Act (SOX) was promulgated in 2002 (United States Congress, 2002). The Sarbanes Oxley Act became the focal point for studies on auditors and audit committees due to new regulations primarily as a result of and in response to the accounting scandals and business failures exposed at the beginning of the 21<sup>st</sup> century (Beasley, Carcello, Hermanson & Neal, 2009:67; Bronson et al., 2009:267; DeZoort, Hermanson & Houston 2008:85; and Tremblay & Gendron 2011: 259-260).

Several studies include reviews of the academic literature on audit committees. The first completed by DeZoort et al. in 2002; followed by Cohen, Krishnamoorthy and Wright, 2004; Turley and Zaman, 2004; Gillian, 2006; Cohen, Gaynor, Krishnamoorthy and Wright, 2007a; Pomeroy and Thornton, 2008; Beasley et al., 2009; Bédard and Gendron, 2010; and Carcello, Hermanson and Ye, 2011. These literature review studies consistently call for more research into audit committee processes. The results of the reviews of academic literature together with various studies on audit committees are further reflected on in section 2.2.3.

Weiss acknowledged that although the body of literature evolves over time and increases the level of understanding of characteristics that could contribute to more effective monitoring mechanisms, however the optimal set of governance characteristics or the optimal definition of a particular characteristic has not been reached (Weiss, 2005:2). Within the South African context there are no optimal characteristics of governance other than the guidelines in the King IV report (IODSA, 2016). A circular has been issued by National Treasury (2012) to assist local government to improve the effectiveness of their audit committees. The application of the circular is further discussed in section 4.3.

Turley and Zaman (2007:767) describe the trends in research on audit committees as moving from the existence of audit committees through studies of voluntary adoption to examination of characteristics (expertise and background of audit committee members) and the association between presence and absence of audit committees and circumstances, including quality financial reporting.

Beasley et al. (2009:71) confirm that most of the research on audit committees examines the relationship between audit committee inputs (characteristics such as independence, expertise and diligence) and the financial reporting outputs (abnormal accruals,<sup>12</sup> restatements,<sup>13</sup> fraudulent financial reporting<sup>14</sup> and auditor going-concern reporting);<sup>15</sup> auditor changes,<sup>16</sup> and stock price reaction,<sup>17</sup> and that the literature fails to research the audit committee processes and the impact of the audit committee. Although the different studies found some correlation between financial reporting characteristics and governance arrangements, Turley and Zaman

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<sup>12</sup> Klein (2002b); Bédard, Chtourou and Courteau (2004).

<sup>13</sup> Abbott, Parker, and Peters (2004); Agrawal and Chadha (2005).

<sup>14</sup> Beasley, Carcello, Hermanson and Lapides (2000).

<sup>15</sup> Carcello and Neal (2000).

<sup>16</sup> Carcello and Neal (2003b).

<sup>17</sup> DeFond, Hann and Hu (2005).

(2004:325) identified the need for further research on the processes and impact unique to audit committees specifically by using the interview method.

In the context of this study, being local government, financial reporting outputs are not that prominent in that there are fewer incentives for the manipulation of financial figures than in the private sector. However, audit committees still need to play an active oversight role over financial information being included in the financial statements, which is discussed further in section 4.7.

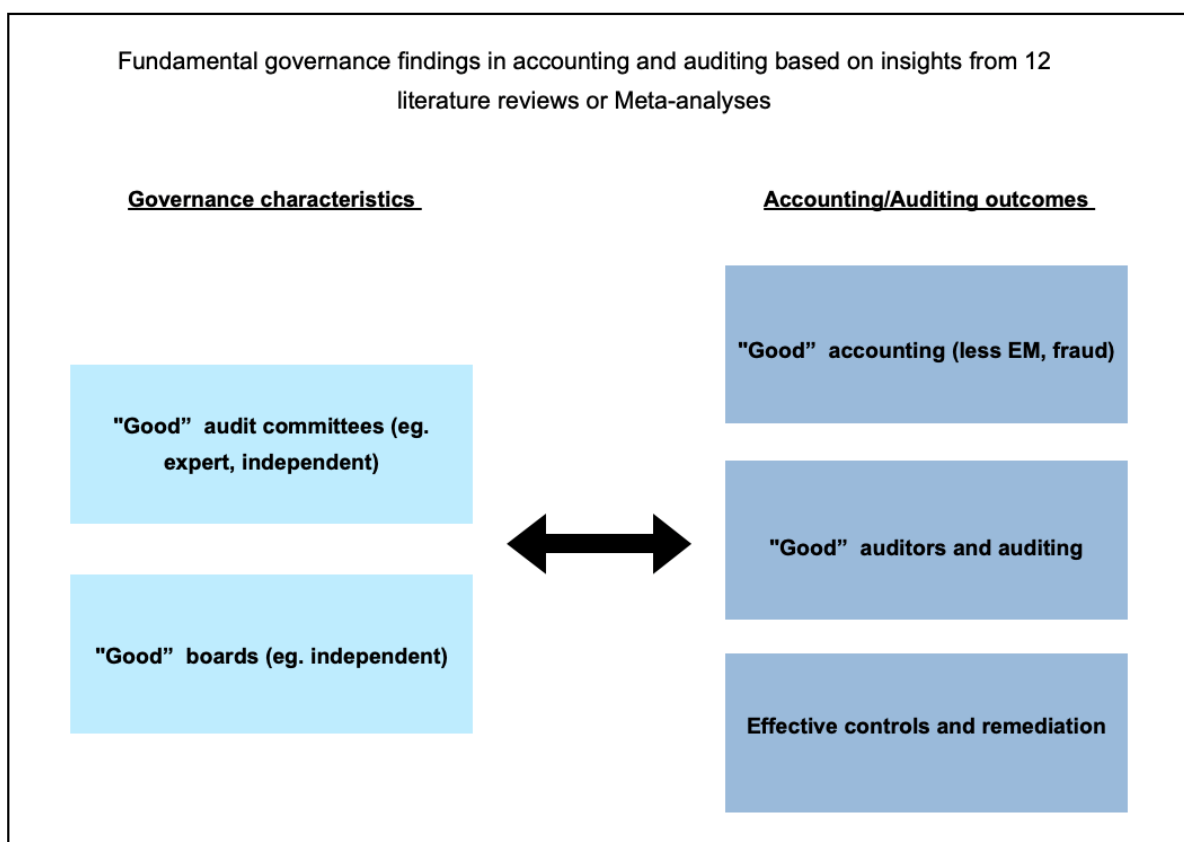
Bédard and Gendron (2010:175) reviewed audit committee literature between 1994 and 2008 to establish whether audit committees perform against increasing regulatory and societal expectations. They were specifically interested in the extension of audit committee effectiveness in relation to financial reporting from the viewpoint of different role-players. They found most of the papers in literature were from a legal or regulatory perspective and mostly from an agency perspective. However, they noted the emerging literature from a sociological and psychological perspective that could be used to interpret behaviours of the AC (Bédard & Gendron, 2010:175). One of the objectives of this study is to determine whether there is an expectation gap between what is required and the expectations of stakeholders.

Carcello et al. (2011:1-2) performed a literature review and synthesis on governance-related literature focussing on corporate board and audit committee issues. The literature review included major themes from 12 governance-related review articles published between 2002 and 2010 and selected findings from the review of over 250 empirical research papers from 2003 to 2010 with the intention to offer recommendations on future corporate governance research in accounting and auditing. Their research was motivated by the need to move beyond all the studies measuring the relationship between corporate governance characteristics and various accounting and auditing outcomes.<sup>18</sup> Factors and questions that triggered the research included the declining use of research findings; the reduction in variation of observable governance characteristics (for example audit committee independence) by way of regulation; and the fact that although management drives governance characteristics and auditing and accounting outcomes, management does not form part of the analysis in most cases (Carcello et al., 2011:1-2). This study specifically addresses the shortcoming by including the views of management - MM, chief financial officer

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<sup>18</sup> The researchers grouped the outcomes into categories of: governance and accounting outcomes, including fraudulent reporting, restatements, earnings management and accounting conservatism; auditing including auditor selection, change and ratification, audit fees, auditor risk assessment and internal audit; internal controls; audit committee financial expertise; audit committee compensation; audit committee processes; and audit committee judgements and the impact of bad accounting on directors (Carcello et al., 2011: 6-9).

(CFO), and those charged with governance, such as the mayor as part of this research. The following figure reflects the results of their findings on the literature review, summarised as 'generally speaking, 'good' audit committee and board characteristics are associated with measures of 'good' accounting and auditing and with more effective controls.' For 'good AC', the research focuses on financial expertise and independence and good accounting is defined as less earnings management or the absence of fraudulent financial reporting or restatements (Carcello et al., 2011:2-3). Research relating to the auditing side includes studies on the auditor type, auditor fees, going concern reporting, and AC-auditor cooperation. With reference to effective internal controls, studies measured Sarbanes Oxley Act, section 404 internal control audit opinions, and effectiveness of internal control under section 302 of the Sarbanes Oxley Act (Carcello et al., 2011:3-4).



**Figure 2.1. Results of literature review findings by Carcello, Hermanson and Ye** (Carcello, Hermanson & Ye, 2011:3).

The analysis of academic research literature further indicates that research on audit committees in the corporate sector centres around externally quantifiable data and the relationship to earnings management<sup>19</sup> or financial performance.<sup>20</sup> The focus of earnings

<sup>19</sup> Studies include Jenkins (2002); Klein (2002b); Bédard et al. (2004); Yang and Krishnan (2005).

<sup>20</sup> Bronson et al. (2009:265) and Klein (2002a:436).

management in the corporate sector is understandable in light of the possible manipulation of the earnings figures by management as a result of incentives, opportunities, and pressures. However, as indicated by Purcell et al. (2014:342), the difficulty of following this quantitative approach for audit committee research in the public sector is that available data, for example number of meetings attended and the tenure, may not have a causal relationship with financial performance. This criticism by Purcell et al. (2014) is considered in the research and is one of the reasons why a qualitative approach was followed.

Suggestions for recommended future research, which is particularly important for this study, include the need to incorporate management into the analysis; the need to address governance processes (what audit committees actually do and how they do it); and to use different research methods including interviews and field studies.

Although there are significant contextual differences between the studies that are discussed for the literature review, it was still considered necessary to review how effectiveness of audit committees is being measured outside South Africa and in both the corporate sector and the government sector. All the studies provide valuable knowledge towards the research topic but the contextual differences, due to diverse circumstances in the South African context, are highlighted and further discussed throughout the literature review.

The first main contextual difference to consider relates to differences between audit committees in the corporate sector and the government sector. Rainey, Backoff and Levine (1976: 236-237) recognise numerous reputable scholars and observers have researched and reported on the differences in public (government) and private organisations (corporate) and summarise the differences based on the extensive literature on the subject. Differences are grouped between environmental factors, organisation-environment transactions, and internal structures and processes.

From an environmental perspective it is identified that government sector organisations have less market exposure resulting in less incentives for cutting costs and operating efficiently and effectively. However, in government there are more constraints on procedures, increased formal specifications and controls, and increased and diverse external and informal influences on decisions. The audit committee has a specific role to play in overseeing compliance that is addressed under audit committee roles and responsibilities in section 4.14. There is also a much greater need for government to support constituencies. From the organisation-environment transactions perspective public administration has a broad impact and symbolic significance and is subjected to greater public scrutiny. There are significant public



expectations that public officials act with fairness, responsiveness, accountability, and honesty. This study specifically includes a focus on the relationship between the audit committee and different stakeholders and explores the possibility of the audit committee playing a symbolic role rather than a substantive oversight role. From an internal structures and processes perspective, for government there are multiple and diverse objectives, less decision-making autonomy and flexibility, more levels of review and greater use of formal regulation, and more political, expository roles for top managers. In government there is more frequent turnover of top leaders due to elections, greater difficulty in devising incentives for effective performance, and lower value of monetary incentives. From a personal characteristic point of view employees in government vary in personality traits and needs, and there is lower work satisfaction and organisational commitment (Rainey et al., 1976: 236-237).

According to Nashwa (2005:42), governance in the public service justifies the same attention as in the private sector. Davies (2009:42) also recognises that the public sector audit committee tends to adopt the private sector audit committee as a blueprint for their own audit committee development. Purcell (2012:28-30) concurs and notes the principles and practices of the private sector are readily transferable to the public sector but at the same time recognises that the public sector has a political representation dimension and legislative requirements that cannot be underestimated. The public sector imposes stakeholder demands and societal expectations on government organisations. He also identifies the distinguishing feature of governance in the public sector versus the private sector, being the emphasis on accountability, stewardship, and prudent decision-making (Purcell, 2012:28-39). While unethical behaviour in the private sector impacts on the shareholders, in the government sector it impacts on taxpayers and citizens (Nashwa, 2005:42). Hardiman (2006:50) observes the increase in the importance of audit committees in the public sector.

These differences demonstrate the importance of examining the audit committee within the specific context and environment in which they operate.

In South Africa, the King IV report explicitly states the applicability of the principles of good governance in both the public (government) and private (corporate) entities and the governance code was drafted to refer to organisations and governing bodies rather than refer to companies and boards of directors (IODSA, 2016:6).

Like in the private section, there is strong support from various academics and professionals for audit committees to be part of government governance structures. Within the different

contextual environment, it is necessary to consider whether there are perceived differences in audit committees in the corporate sector versus the government sector.

The Director of Standards of the Independent Regulatory Board for Auditors (IRBA) made the following statement:

“Whether it is the taxpayer’s money or hard-earned investments of shareholders in the private sector that are being spent, it has become increasingly important that there are proper structures in place to exercise some oversight over the management of others’ funds. One such structure is the audit committee” (Agulhas, 2006:30).

Magrane and Malthus (2010:427) state that the aim of the audit committee is to improve organisational governance and, in that regard, it does not matter whether it is in the private or public sector (2010:427).

The Institute of Internal Auditors (IIA) (2014:15) states an effective audit committee helps to ensure credible information to enable better decision-taking to the benefit of the community and society and recognises many similarities between audit committees in the government and private sector, although it identifies the one significant difference to be the 'public interest' that applies to government sector audit committees. The IIA (2014:15), based on the International Federation of Accountants, describes the term 'public interest' as:

“The net benefits derived for, and procedural rigour employed on behalf of, all society in relation to any action, decision, or policy.”

Purcell (2012:3) also emphasises that accountability in local government has a broader dimension than in the private sector. Accountability in the private sector relates to the management of business interests for the shareholders while in local government accountability is multifaceted as a result of diverse social, political, and financial goals for the community. He states that governance in local government is like corporate governance in the private sector but has the political dimension of elected councillors. Local government has legislative and taxing powers and has to provide services. There could also be competing stakeholder demands that range from expectations from government for delivery of services, the 'needs' and 'wants' of the community, expectations from users of council services, and motivations and personal agendas of councillors (Purcell, 2012:30).

If the difference of public interest is considered, it further signifies the important role of the audit committee in the government sector. Magrane and Malthus (2010:428) agree and consider the role of audit committees in government to be so important that they recommend

for audit committees in the public sector to be legislated, due to the size, complexity, and social significance of the government sector compared to the private sector in New Zealand.

In South Africa, audit committees in the government sector are legislated in sections 76 and 77 of the Public Finance Management Act, (1 of 1999) (RSA, 1999), together with Treasury Regulations 3.1.2 and 27.1.1 (for national and provincial departments and public entities) (RSA, 2001c) and in section 166 of the Municipal Finance Management Act (56 of 2003) (RSA, 2003) (herein referred to as MFMA). The legislative roles and responsibilities of audit committees in local government are further discussed in section 4.3 of the study.

Van der Nest (2006:179), in his study on effectiveness of audit committees in the public sector in South Africa, also recognises the similarities in functions and responsibilities between the government and private sector audit committees but at the same time highlights the differences in the environment between the two sectors. Van der Nest refers to special challenges to audit committees due to the uniqueness of the government sector including the number of regulatory agencies providing oversight and the financial reporting and regulatory framework consisting of divergent pieces of legislation. The recent allegations of state capture of public entities in South Africa as well as the findings of the Auditor-General on the public sector in South Africa illustrates that governance in the public sector can fail.

Chapter 4 of this study analyses the roles and responsibilities of audit committees in detail. The analysis of roles and responsibilities reveals many similarities between audit committees in the government sector and private sector. However, there might be legislative requirements and the resultant focus that could differ between the two sectors' audit committees. For example, one of the mandated functions of AC's in the private sector is the hiring, retaining, and overseeing of the external auditor (Gabre, 2008:39). In South Africa, the Auditor-General conducts the external audits in the government sector and the audit committee plays no role in the hiring and retaining of the auditor (IODSA, 2016: 84). The Public Audit Act, (25 of 2004) (RSA, 2004) describes the legal status of the Auditor-General to be the supreme audit institution of the Republic of South Africa with full legal capacity, that is independent, must be impartial and must exercise the powers and perform the functions without fear, favour or prejudice (Chapter 2: par 3). The constitutional functions of the Auditor-General include, *inter alia*, the audit and report on the accounts, financial statements, and financial management of all national and provincial state departments and municipalities (Chapter 2: par 3). Audit committees in the public sector therefor play no role in the appointment of external auditors. The role of the AC, to oversee external audit and the independence of external audit in the

public sector, is also limited in comparison with the private sector, but this is further discussed in section 4.11 of this study.

There is overwhelming support for audit committees in government and although there are some differences in the roles and responsibilities of audit committees between the private and public sector, valuable lessons can be learnt from research on the effectiveness of audit committees in the private sector. However, it is important to be cognisant of the differences in legislative requirements and the uniqueness of the different environments during the research.

As indicated earlier many of the studies on the effectiveness of audit committees originate from the USA, distinguishing between pre- and post-Sarbanes Oxley Act implementation. The review of the studies contributes to relevant and useful information on the theoretical base used for the research on audit committee effectiveness and the measurement criteria or determinants of effective audit committees in the corporate and government sector. It is recognised that contextual and environmental differences exist, but it is considered necessary for this study to analyse the theoretical bases that were used in the different studies on audit committee effectiveness. The results of the studies and the relevance and applicability of the different theoretical bases are further elaborated on in the next sections, followed by measurement criteria and determinants of effective audit committees used in different research studies.

### **2.2.1 Theories underlining the research question**

This section covers theoretical bases used in governance studies and studies on audit committees as part of the governance framework. Theoretical bases used for studies on audit committees specifically include the agency theory (section 2.2.1.1), the resource dependence theory (section 2.2.1.2), institutional theory (section 2.2.1.3), managerial hegemony theory (section 2.2.1.4), practice theory (section 2.2.1.5), and a hybrid of theories (sections 2.2.1.6-2.2.1.7). The different theories provide interpretative views in the assessment of the effectiveness of audit committees and forms the basis of the discussion of the determinants of effectiveness included in Chapter 5.

The academic literature review indicates the agency theory, as a theoretical base, is used in most of the studies on governance including boards and audit committees (Bathala & Rao, 1995:59; Baysinger & Hoskisson, 1990:73; Brennan & Kirwan, 2015:475; Carcello et al., 2011:18; Cohen, Krishnamoorthy, & Wright, 2008:182; Daily, Dalton, & Cannella, 2003:371; Hillman & Dalziel, 2003:383; McNulty, Zattoni, & Douglas, 2013:195; and Turley & Zaman,

2004:325). Daily et al. (2003:372) argue that the reason for the popularity of the agency theory is due to two factors, it being an uncomplicated theory and the impression that humans are self-interested and unwilling to disadvantage themselves for the interest of other. The regular use of the agency theory is also demonstrated in the summary of post graduate research studies consulted as part of the literature review and included in Annexure 1. As indicated earlier on, most of the studies on audit committee effectiveness focus on the corporate sector, whereby the directors provide oversight on behalf of the shareholders to ensure that management act in the best interest of the shareholders, which explains the use of the agency theory in most of the research. However, for this study it is considered necessary to evaluate the appropriateness of the agency and other theories in the measurement of audit committee effectiveness. Carcello et al. (2011:19) makes the following statement in this regard:

In terms of theory development, most governance research is based on the agency theory. However, there are multiple theories of governance – e.g., resource dependence theory (the board's main role is to assist management in securing key organisational resources), institutional theory (governance mechanisms may be somewhat ceremonial, designed to enhance external legitimacy but loosely coupled with actual oversight), and managerial hegemony theory (board members are friends and cronies of management)...One research area where multiple theoretical perspectives have been used relates to audit committees processes...Researchers often find that audit committee members interviewed about governance processes provide responses that are consistent with a mix of governance theories.

Brennan and Kirwan (2015:475) find that only four of the 20 papers reviewed use a theoretical perspective other than agency. The four papers include that of Beasley et al. (2009:66) which combined agency and institutional theory; Spira (1999a:236) which uses the actor-network theory; Gendron and Bédard (2006:212), which uses sociological theories; and Beattie, Fearnley and Hines (2014:349), which adapts theories from the organisational behavioural theory including elements of the resource dependency theory. The different studies are further elaborated on in this section.

Purcell (2012:9), in his study on audit committee effectiveness in Victorian local government, discusses the governance theories of agency theory, institutional theory, and resource dependency theory, referred to as 'often but sometimes complementary theories with regard to corporate governance and audit committees' by Beasley et al. (2009:69).

Smallman (2007:242) recognises the need for research in corporate governance to clarify similarities and differences in theories to provide for theoretical integration and to contribute

towards a comprehensive understanding of governance and the complexity thereof. Corley and Gioia (2011:27) also urge for the need to pursue a practice view of knowledge generation as the most influential theories have been formulated for scholars but have major pragmatic implications. Theories or theoretical perspectives, other than the agency theory, used in research on audit committees include the resource dependency theory, the institutional theory, the managerial hegemony theory, practice theory, signalling theory, and a hybrid of theories. The section begins by explaining and analysing the different possible relevant theoretical perspectives and concludes on the appropriate theory/theories for this research.

### *2.2.1.1 Agency theory*

Agency theory refers to a contractual relationship between a principal and an agent. The principal appoints the agent to perform a service on their behalf that requires the delegation of decision-making authority to this agent. For the agent to perform the task requested by the principal, there must be an appropriate incentive and adequate monitoring by the principal to ensure the agent completes the task efficiently (Jensen & Meckling, 1976:308). This comes with a cost whereby the agent may incur an opportunity cost in completing the task and the monitoring of the agent may be difficult depending on the nature of the task. An important activity of the board is to monitor management on behalf of the shareholders thereby improving firm performance and reducing agency costs (Cohen, Krishnamoorthy & Wright, 2010:773, and Hillman & Dalziel, 2003:383).

To mitigate the agency problem resulting from management (agents) not always acting in the interests of the shareholder (principals), board of directors need to fulfil an oversight role over various activities, for example appointing the chief executive officer, approving business strategy, monitoring control systems, and liaising with external auditors. The main attributes for a board member in the agency perspective are independence from management and expertise in monitoring and control (Cohen et al., 2008:183). Audit committees are appointed to support the board of directors in the governance oversight and monitoring (Myers, 2001:14).

Wayne (2003), in his study on the determinants of audit committee effectiveness, identified two perspectives for evaluating the effectiveness of AC: the agency perspective<sup>21</sup> and the institutional perspective. The agency perspective assumes conflicting objectives between managers (agents) and shareholders (principals) and the audit committee has the

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<sup>21</sup> Other researchers that supported the theory include Felo, Krishnamurthy and Solieri (2003:10); Keasey and Wright (1993: 293); McMullen (1996:88), and Weiss (2005:1), and found a positive association between the existence of an audit committee and the quality of financial reporting.

responsibility to monitor management and ensure the interest of the shareholders are protected. An effective audit committee would ensure the financial statements prepared by management are reliable, which would result in higher quality financial reporting. The effective audit committee would rely on the expertise and experience of auditors (internal and external) to assist with the monitoring function (Wayne, 2003:33-34). Wayne (2003:37) admits the agency perspective rates only moderately in explanatory power and suggests in some circumstances the attributes one would expect from an agency viewpoint are not associated with higher quality financial reporting. The effective audit committee from an agency perspective would have the technical resources to monitor and control and they would be sceptical of management because of the agency assumption that management is more concerned about their own interests than that of the shareholders (Wayne, 2003:38).

In the research on corporate governance and agency conflicts, Dey (2008:1144-1145) recognises numerous conflicting interests arise as a result of the separation of ownership and control, different management and shareholder objectives, and information asymmetry between managers and shareholders. The agency conflicts can result in a situation that is not in the best interest of shareholders, for example the consumption of corporate resources as privileges, avoidance of optimal risk investments, and manipulating financial figures to optimise compensation. To mitigate the agency conflicts, governance structures need to be established. Dey's (2008) study specifically focuses on whether the level of agency conflicts is associated with governance structures, thereby providing information on the link between various aspects of governance and the impact on organisational performance and whether it can be made applicable to all firms or only for certain types of firms. One of the individual governance variables included in the study is the structure and functioning of the AC. The researcher found firms with higher agency conflicts had governance structures (specifically the composition and functioning of the board of directors, audit committees, and independence of auditors) and that the demand for higher quality governance is greater in firms with a greater need of oversight (Dey, 2008:1144-1145). The conclusion further states evidence from the research support the argument that 'one size does not fit all' (Dey, 2008:1175), making the case for the methodology followed in this research stronger, namely using the case study method through in-depth interviews.

In their description of the agency view, Beasley et al. (2006:69) refer to the audit committee being in place to monitor management that might act in their personal best interests rather than that of the principal and that independent members of the audit committee monitor management to prevent opportunistic behaviour.



Purcell (2012:31) identifies the key assumptions of the agency theory to be individuals acting in their own interest; agents acting to maximise their own benefit in case of conflict with the principal; and the agent being in a unique position to further his own interests due to access and control of information.

The primary focus of accounting and auditing research, using the agency theory, is on the independence of the board and audit committee members, the required competencies and skills of audit committee members, and the value thereof to the shareholders including the reduction of agency costs. Both the requirements of independence and competencies and skills of audit committee members are further reflected on in Chapter 5 - determinants of effective audit committees.

Strickland (2011) as part of her research on local government audit committees, also refers to the agency theory. She recognises that MMs act as agents on behalf of citizens and are subjected to agency issues. However, she states the agent-principal model in local government is not straightforward and limited empirical evidence about public sector board governance is available. In local government the contractual relationship between citizens and the MM is mandatory in contrast with the private sector where the contractual relationship is not. Where citizens are not satisfied with the oversight of agents they cannot, as in the private sector choose other investment options. They can merely relocate to another municipal area (Strickland, 2011:12).

The agency theory in the South African context can be explained by referring to the supplement for municipalities in the King IV Report on corporate governance. According to principle 6 of the King IV Report, the council serves as the custodian of corporate governance in the municipality (IoDSA, 2016:82). Through the voting process the constituency appoints the council. The Constitution of South Africa (RSA, 1996) in section 151 assigns both legislative and executive authority to the council. Audit committees are appointed by council as a sub-committee to assist council in fulfilling its governance and oversight role. Community members can be regarded as shareholders. In terms of the agency theory the shareholders (principal), through the council (governing body) appoint management (agency) to act in the best interests of the citizens/community (shareholders). As such the main attributes for the AC, being appointed by the council, in terms of the agency theory, should be independence and expertise when they perform the functions of monitoring and control.

Various criticism against the agency theory have been expressed (De Zoort et al., 2002:41; Eisenhardt, 1989:71; Turley & Zaman, 2004:325; and Turley & Zaman, 2007:767). Some of



the criticism raised against the agency theory is that it presents only a partial view and ignores a large portion of the complexity of organisations. Research by Turley and Zaman (2004:324) recognises the need for audit committees to be the primary subject of research rather than using other variables. They found a limiting feature on audit committee research is the focus on topics such as independence, auditor tenure and financial reporting quality rather than the primary subject being the AC. The fact that the audit committee is often the secondary concern in research design limits the contribution to the understanding of audit committees and their effects (Turley & Zaman, 2004:324).

Turley and Zaman (2004:325) conclude as follows:

“audit committees do not operate in a vacuum and their operation and effects cannot be adequately examined without regard to the institutional and organizational context in which they function and the power relationships which are intrinsic to that context.”

The above is one of the main reasons this research includes examining the audit committee processes by way of a case study with regard to the organisational context.

In later research, Turley and Zaman (2007:767) state that the complexities of organisational settings and power relations within organisations and the nature of the businesses are not properly represented by using agency models and an approach should rather focus on audit committees within the organisation.

Smallman (2007:241) also refers to the following two quotes to indicate the limitations of the agency theory:

... [any explanation of] organizational behaviour solely in term of agency ...[which] ignore[s] key organizational mechanisms like authority, identification, and coordination ...[is] ... seriously incomplete (Simon, 1991:30).

and

...it is most curious that despite the lack of both face validity and empirical support, agency theory continues to dominate academic research on corporate governance (Ghosal, 2005: 81).

Another main criticism against the agency theory is the effect management may have on the governance processes is ignored and the theory assumes if boards (council) and audit committees are independent and have the competencies and skills they will be effective monitors of the activities of management. However, management is an important part of the corporate governance framework and may have a significant influence on, for example, who is appointed to the AC. During the fieldwork of this research the sometime important role

management, and specifically the MM, plays in the audit committee appointment process is highlighted and discussed in Chapter 7.

Management could also override internal controls affecting the effective monitoring by governance structures. Cohen et al. (2002:582) observe governance mechanisms are unlikely to be effective if senior management does not want to be governed. Wayne (2003:4) concurs and states the results of research on audit committee effectiveness based on the agency perspective is only moderate in explanatory power. Only relying on the agency perspective might limit understanding the roles and responsibilities and importance of corporate governance (Cohen et al., 2008:182-183). As discussed in more detail in Chapter 4, audit committees in local government should play an advisory role according to the relevant legislation. Some of the participants during the fieldwork alluded to the fine balance that needs to be maintained by the audit committee in providing advice versus interfering with management at municipalities. It was strongly felt that the audit committee can provide advice, but ultimate decision-taking lies with management and the council. For this study and in line with addressing some of the criticism against the agency theory, management's views formed an integral part of this research.

Cohen et al. (2002:573) examine the impact of various corporate governance factors, including the audit committee on the audit process. They find that auditors view management as the primary driver of corporate governance. It is therefore essential to consider management as part of the corporate governance framework, which is inconsistent with the agency theory prescribing of the governance mechanisms to be independent in overseeing management actions to protect shareholders (Cohen et al., 2002:573).

Although the agency theory can be applied in the context of the role of the audit committee in local government, in my opinion and due to the partial view presented, using the agency theory would not do full justice to this research. Within the local government, council can be equated to the governing body and management can be equated to agents appointed by the governing body to act in the best interest of the community and public. Audit committees should ensure management is acting in the best interest of the community members through monitoring and control and report to council whether this is achieved. One of the main arguments for appointing governing bodies and therefore audit committees is to reduce possible costs incurred by management due to a conflict of interest and not acting in the best interest of the community (agency costs). However, in the public sector, the opportunity for management to incur such costs are heavily regulated by way of rigid legislation and regulations. Strictly speaking high agency costs should therefore not be as an important factor in the government

sector as in the private sector. However, if one analyses the extent of irregular,<sup>22</sup> fruitless and wasteful,<sup>23</sup> and unauthorised expenditure<sup>24</sup> in local government, reported by the Auditor-General on an annual basis it seems irresponsible not to consider agency costs and therefore the agency theory as part of this research. The year-end balance of irregular expenditure that had accumulated over many years and had not been dealt with totalled R65.32 billion, while unauthorised expenditure was 43.5 billion, and fruitless and wasteful expenditure was R4.24 billion (AGSA, 2018:2). The Auditor-General also indicated only 33 (13%) of the total 257 municipalities are in full compliance with the relevant legal requirements and produced quality financial statements and performance reports (The Conversation, 2018a).

The limited view/partial view as an argument against the agency theory needs to be considered for this research. Within the agency theory the role-players or stakeholders will be the council and audit committee (appointed by the council to perform specific functions) acting as the governing body and management acting as agents, that needs to be monitored on behalf of the community or public. If this research is limited to independence and monitoring ability of the governing body it would provide a very narrow scope, ignoring other significant role-players and factors impacting on audit committee effectiveness.

Due to the dominance of the agency theory in corporate governance research the research tends to only characterise audit committees to exercise a monitoring and oversight role.

Due to the limitations of the agency theory and the extended role of audit committees it is considered necessary to explore theories other than the agency theory for this research including resource dependence theory,<sup>25</sup> institutional theory, and practice theory, as well as a hybrid of agency, resource dependence, and other theories. The alternative theories are discussed in the following sections.

### *2.2.1.2 Resource dependence theory*

Resource dependence theory gained momentum after the often-quoted publication of Pfeffer and Salancik's in 1978 on the resource dependence perspective (Hillman, Withers, & Collins

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<sup>22</sup> Irregular expenditure is defined in the MFMA to mean expenditure incurred in contravention of or not in accordance with a requirement of the MFMA and which has not been condoned.

<sup>23</sup> Fruitless and wasteful expenditure is defined in the MFMA to mean expenditure that was made in vain and could have been avoided if reasonable care had been exercised.

<sup>24</sup> Unauthorised expenditure means expenditure incurred contrary to the amount, purpose and conditions approved in the budget.

<sup>25</sup> In the literature resource dependence and resource dependency is used interchangeably. For this thesis, the term 'resource dependence theory' is used.

2009:1404). The resource dependence theory developed in the strategic management literature and focuses on corporate governance and the positive impact thereof on the achievement of objectives (Boyd, 1990:419; Cohen, Krishnamoorthy & Wright, 2007b:93; Cohen et al., 2008:182). According to Hillman et al. (2009:1404), resource dependence theory is one of the most influential theories in organisational theory and strategic management. The link between resource dependence and firm performance proposes that resources help to reduce the dependency between the organisation and external eventualities (Pfeffer & Salancik, 1978:258) and reduce uncertainty (Pfeffer, 1972:219). Resource dependence theory asserts that stakeholders rely on the board of directors to gain access to scarce resources and information (Boyd, 1990:419).

In the 1978 publication, Pfeffer and Salancik identified five actions organisations can perform to minimise environmental dependences and contribute to continuous success. The one<sup>26</sup> action specifically relevant to this research relates to boards of directors and is considered to be the area in which resource dependence theory has had the greatest research influence. Further exploration of the resource dependence theory for this study is important. This study focusses on audit committees being a sub-committee of the council (board of directors) with the specific role of advising council and management.

To evaluate the appropriateness of the resource dependence theory for this research it is necessary to study the description and value of the theory as described by different researchers. The theoretical basis of the provision of resources function of the board is described in the work by Pfeffer and Salancik (1978:163), who state that ‘when an organization appoints an individual to a board, it expects the individual will come to support the organization, will concern himself with its problems, will variably present it to others, and will try to aid it’. According to Wernerfelt (1984:172), the provision of resources function of the board means the ability of the board to bring resources to the firm and resources could be anything related to strengths or weaknesses of the given organisation. In the resource dependence theory, the less explored path according to Hillman and Dalziel (2003:383), the focus is on the *board capital* that refers to human capital (experience, expertise, and reputation) and *relational capital* (network of ties to other firms and external contingencies).

Pfeffer and Salancik (1978:161) propose that directors bring the following four benefits to the organisation: information in the form of advice and counsel; access to channels of information

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<sup>26</sup> The other four include mergers/vertical integration, joint ventures and other organisational relationships, political action, and executive succession.

between the firm and environmental contingencies; preferential access to resources; and legitimacy. Dalton and Daily (1999:32) indicate a benefit of the theory is that it improves a company's long-term success due to the board members connections enabling the entity to access strategic resources, networks, and information. For board members to facilitate the bringing of the resources to the table they need the attributes of industry expertise, knowledge in helping set corporate strategy and providing access to external resources. The benefits were confirmed in subsequent research.<sup>27</sup> During the fieldwork, further described in Chapter 7, the critical importance of the information audit committee members bring to the table in the form of advice was recognised by many of the participants.

Earlier studies using the resource dependence theory focussed mostly on board size and composition to provide critical resources to the organisation. Boyd (1990:428) suggests that resource-rich directors should be the focus of board composition considering not only the number of directors but also the type of directors. Participants in this study, also referred to in Chapter 7, strongly felt the audit committee composition mix should include various areas of expertise providing for the resource-richness referred to by Boyd (1990).

Nicholson and Kiel (2007:585), in their study on the link between firm performance and the demography of the board, used the three theories of agency, stewardship, and resource dependence to analyse seven cases. The authors find that although each theory can explain a specific case there is no single theory that explains the pattern of results and they recommend a more process-orientated approach to analysis and understand the value added by boards. This is similar to the present study, which also explores specific cases (municipalities) and focuses on processes rather than the input: output relationship alone. Their findings state that although board roles were described over 20 years ago the theories to explain them are only developed and investigated much later. It is also argued by the researchers that the hard sources previously used are unlikely to capture the soft nature of relationships and when it is investigated what boards do, a more integrated model of all the elements of existing theories can be developed (Nicholson & Kiel, 2007:602).

The use of resource dependence theory has been receiving continued support. Daily et al. state the following: 'Rather than focussing predominantly on directors' willingness or ability to control executives, in future research scholars may yield more productive results by focusing on the assistance directors provide in bringing valued resources to the firm and in serving as a source of advice and counsel for CEOs (2003:375). Cohen et al. (2007b:94) support the

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<sup>27</sup> Kor and Misangyi (2008:1351); Lester et al. (2008:1008).

combination of strategic and networking skills and the need for strong financial monitoring. According to Hillman et al. (2009:1411) resource dependence theory in board of directors' research has seen the greatest application over the last 30 years with increasing empirical evidence supporting resource dependence theory and boards indicating continued future application. Although the resource dependence theory is less used to study boards in comparison with the agency theory the empirical evidence suggests it provides a more effective method of understanding boards (Hillman et al., 2009:1408).

Hillman, Nicholson, and Shropshire (2008:411) model the influence of directors' multiple identities on monitoring and resource provision. They propose that directors' strength of identification with multiple identities affects the extent to which they engage in monitoring and resource provision that impacts when a director will provide advice and counsel using their external connections. A typical example of this could be in case of a dispute between management and the external auditor over the application of a specific reporting standard. The audit committee member could access information from the technical divisions of employers like auditing firms to advise or facilitate the resolution of the dispute.

The preceding discussion on research using the resource dependence theory is in the context of board of directors. However, it was also used in other governance studies. One of the few auditing studies to consider resource dependence found it can add value to the governance structure and that the auditor's control risk assessments are significantly affected by both resource dependence and agency factors (Cohen et al., 2007b:91). The study by Cohen et al. (2007b:91) consists of the evaluation by 68 audit partners and managers of a case where the roles of the board were manipulated to reflect an agency role and resource dependence role. The purpose of the study was to examine how the roles played by the board impacts on the auditor's risk assessments and program planning. The researchers found a significant variance between a strong board and a weak board in that audit planning increased when the board was considered to be weak and that auditors were prepared to reduce audit effort when the board was strong on monitoring and providing resources (Cohen, 2007b:93). The research results imply that auditors do not only focus on the monitoring role (as per agency theory) but also the complexity of the organisation, the role of the governing body, control of misstatements, and business risks. They concluded that if research is limited to the monitoring perspective (based on the agency theory) the richness that alternative roles of governance provide might be lost (Cohen, 2007b:108).

Other auditing studies that focussed on resource dependence included the effect of the auditor industry and financial expertise on audit judgements (Moroney, 2007:69; Owhoso, Messier &

Lynch, 2002:899) and financial reporting quality (Kwon, Lim & Tan 2007:25; Krishnan 2005:651, and Gramling & Stone, 2001:25).

The possible use of both agency and resource dependence theories were confirmed by Cohen et al. (2008:190):

“...an auditor can emphasize both the agency and resource dependence perspectives in considering mechanisms used to monitor management, as well as those adopted to develop sound corporate strategies and control business risks. Using this approach, the auditor would consider whether a sufficient balance between independent and industry expertise is achieved” (Cohen et al., 2008:190).

Some criticism or limitations of the resource dependence theory are reflected on by Nicholson and Kiel (2007:601). They conclude, as in the case of agency and stewardship theory, that resource dependence theory only focuses on a single aspect of the board's performance, being the interaction with the external environment to access critical resources, and ignores alternative action such as providing advice, monitoring, and strategising.

The above research reflected mostly on the relevance of resource dependence theory in the context of the board. However, the audit committee is a sub-committee of the board and some research on audit committees also used the resource dependence theory as a theoretical base.

The argument for the use of the resource dependence theory is based on two main points. Firstly, having resource-rich members on the audit committee has proven to be beneficial to organisations. Research suggests significant association between the audit committee accounting financial expertise and the stock market reaction (DeFond, Hann & Hu, 2005:153) and financial reporting quality (Dhaliwal, Naiker & Navissi, 2010:820). Further research on the associations between audit committee characteristics and value added to organisations is discussed in the next section on the analysis of studies on audit committee effectiveness.

In the resource dependence theory, the focus is on the experience, expertise, and reputation of the members and the network of ties to other firms and external contingencies. The benefits proposed by Pfeffer and Salancik (1978:161), being advice and counsel, legitimacy, enabling communication between external organisations and the firm, and preferential access to support from important elements outside the firm, are benefits that can be brought about by having audit committees. Furthermore, legislation requires the audit committee in local government specifically to play an advisory role to both the council and management, making



the application of the resource dependence theory relevant for this research. Section 166(2) of the MFMA (RSA, 2003) describes the role of the audit committee to advise the municipal council, the political office-bearers, the accounting officer, and the management of the municipality or municipal entity on matters relating to internal financial controls and internal audits, risk management, accounting policies, the adequacy, reliability and accuracy of financial reporting and information, performance management and effective governance, compliance with the applicable legislation, performance evaluation, and other issues referred to it by the municipality and municipal entities under the sole control.

Cohen et al. (2008:185) make the following statement:

“Given that a resource-dependent focus of the board may contribute to effective governance, an audit committee with a resource-dependent focus evinced through industry expertise of the members may significantly improve the effectiveness of the audit committee.”

Governance areas where audit committee members with strong industry experience (required by the resource dependence theory) can add value include risk management and high-quality financial reporting (Cohen et al., 2008:185). Other areas in local government where value can be added through experience include performance management and the audit of performance information, combined assurance, and internal controls. The role of the audit committee in the different areas is further discussed in Chapter 4. Throughout the fieldwork (see Chapter 7) participants emphasised the importance of audit committee having experience about government and local government specifically.

Relating to the description of the resource dependence theory to this research on the effectiveness of audit committees, a clear case can be made for the possible use of the resource dependence theory. It needs to be emphasised in the context of local government the audit committee can be seen to be an extension of the council being appointed by the council, and through legislation is required to advise council on matters relating to governance areas including risk management, performance management, internal controls and internal and external audit. The reason why this is important for this study is that the audit committee being a sub-committee of the council within local government need to bring skills to the council in the areas where the council members lack the skills including in the areas of internal controls, risk management, and governance.

During the fieldwork, parties affected by the audit committee acknowledged the benefits of advice and counsel, legitimacy, and effective communication the audit committees bring in line with what Pfeffer and Salancik (2009) professed. However, in practice and specifically in



local government in South Africa, at some of the smaller and more remote municipalities, access to resources who are independent and possess industry knowledge and expertise (local government) to fulfil the roles and responsibilities of audit committees is a significant challenge (see Chapter 7).

Hillman et al. (2008) posit that although strong support exists for Pfeffer and Salancik's (2009:1416) assertions and the benefits directors can bring to organisations, scholars still call for a multi-theoretical view of boards, particularly one including agency theory. The researchers conclude that there is much potential in integrating other theoretical perspectives with resource dependence theory that will offer new insights in the relationship between the organisation and its environment. They recommend the application of resource dependence theory in the study of boards that could evaluate the human/social capital needed on the board to provide the benefits envisaged by Pfeffer and Salancik in 1978 (2009:1416).

Both discussion of agency theory and resource dependence theory indicate that the limitations of the theories (the restricted view it provides) opens up the possibility of combining the two theories. The possibility of combining agency and resource dependence or other theories are discussed after the feasibility of the institutional, managerial hegemony, and practice theories are considered.

### *2.2.1.3 Institutional theory*

The institutional theory developed in the sociology of organisations and organisational behaviour literature (Cohen et al., 2008:183; Powell, 1991:184).

DiMaggio and Powell (1983:150) explain the essence of institutional theory in an institutional environment entity that is shaped by wider cultural, social, and symbolic elements. Purcell (2012:76-77) summarises the view of DiMaggio and Powell (1983) as follows: 'the theory is a way of defining organisational structures and the social process through which these structures develop. Institutional theory is set within the dynamics of an organisation and its institutional values, in addition to the ceremonial structures that people within the dynamic display'. Kalbers and Fogarty (1998:131) in their description of institutional theory suggest that organisational structures become symbolic displays to indicate conformity and demonstrate social accountability. Cohen et al. (2002:579; 2008:187) also refer to governance structures in certain cases fulfilling a ritual role to help in legitimising the interactions between various role-players.

It is important for this study to determine whether the structure of the AC, for example consisting of three members because most audit committees consist of three members, and the appointment of audit committees being a symbolic display to indicate conformity rather than providing substantive monitoring and value adding services to the various stakeholders. Chapter 7 provides an analysis of ceremonial versus substantive role the audit committee members play as perceived by the interviewees.

Scott (2004:409) states that the institutional theory: 'examines the processes and mechanisms by which structures, schemas, rules and routines become established as authoritative guidelines for social behaviour'.

Cohen et al. (2008:183) state:

"...institutional theory suggests that it is necessary to understand the substance of the interaction between different governance parties and how these parties use at times symbolic gestures and activities to maintain their form to all relevant parties."

The institutional theory description provided above focus on the organisational structure and the impact thereon. From an audit committee perspective Spira's (1999a:256) observation of institutional theory suggests that '...organisational legitimacy may be secured by the use of myth and ceremony to link organisations to their external environments: the establishment of audit committees appears to offer an example of this process'.

The use of the institutional perspective or principles thereof in research on audit committees are supported by many researchers including DeZoort, 1997:209; Kalbers & Fogarty, 1993:36; Kalbers & Fogarty, 1998:132; Spira, 1999a:236; and Spira, 1999b:262.

Spira (1998:34) recognises the effectiveness of the audit committee is measured by the stature it brings to the organisation through the association with the members and the ceremonies surrounding audit committee meetings.

Wayne (2003:38) explains institutional theory in the context of audit committees as follows: Adoption of specific structures such as audit committees, is used by organisations to signal compliance with 'rational' expectations and thereby gain legitimacy. From this perspective, the audit committee is adopted to conform to societal expectations in a bid to secure and maintain external indicators of respectability...Therefore, the adoption and operation of an audit committee is primarily symbolic or ceremonial...Effectiveness is suggested by the stature brought to an organisation through the association with the members of the audit committee...

During the fieldwork, the importance of the standing of the audit committee members, and specifically the chairperson, was considered essential by different interviewees.

Weiss (2005:2) also recognises the 'appearance of monitoring' by audit committees with certain characteristics to prevent lawsuits or discourage regulators from getting involved with internal governance processes.

The one implication of institutional theory in the understanding of corporate governance, according to Cohen et al. (2008; 2012), is in periods of uncertainty the board and audit committees could emphasise ceremonial and symbolic roles. In these instances, individuals could be chosen based on their discernible credentials and not necessarily their ability to effectively monitor (Cohen et al., 2008:187). Purcell also refers to the relevance of institutional theory for external stakeholders to create a perception of trust and competency in the processes and practices of the audit committee (Cohen, 2012:77).

DiMaggio and Powell (1983:150) and other researchers posit that organisations become similar over time because they evolve to become similar to other organisations around them through the process called institutional isomorphism (Barreto & Baden-Fuller, 2006:1559; Cohen et al., 2008:186; Dacin, 1997:48; Dillard, Rigsby & Goodman, 2004:509; Gendron, Bédard & Gosselin, 2004:155; Powell & DiMaggio, 1991:66; Stainbank, 2017:11 and Tuttle & Dillard, 2007:389). DiMaggio and Powell (1991:67-70) categorise institutional isomorphism into coercive, normative, or mimetic isomorphism and predict that control structures will gravitate towards common social forms. DiMaggio and Powell (1991:67) indicate coercive isomorphism result from formal and informal pressures on organisations by other organisations upon which they are dependent and pressures in the form of cultural expectations from the society in which the organisation functions. It could be in direct response to government mandate and the change could be ceremonial but not necessarily inconsequential. Mimetic processes can occur when organisational technologies are not well understood or the environment creates symbolic uncertainty with the result that organisations model themselves on other organisations (DiMaggio & Powell, 1991:69). Normative pressures originate from professionalisation and could be from formal education and professional networks (1991:70). Coercive isomorphism occurs due to regulatory-type pressure, mimetic isomorphism occurs through formal and informal channels such as industry guidelines and common practices, and normative influence derives from the professionalism of involved individuals (Kalbers & Fogarty, 1998:133).

Purcell (2012:78) recognises that the implications of institutional theory for audit committees are the inclination for members to conform to the practices of audit committees in other organisations and over time display similar characteristics. This has been specifically observed in the Western Cape local government environment, where due to the limited number of considered available audit committee members, the members rotate between municipalities resulting in similar practices in different organisations over time. According to the researchers, if a field of study becomes engrained, there is a tendency to conform to norms and values resulting in producing similarity for similarity's sake (Purcell, 2012:78).

In the context, the governance structures and activities may be the sole reason to establish or confirm legitimacy resulting in the activities and structures being ceremonial and only being symbols of effective oversight (Cohen et al., 2008:187).

Within the South African context in local government, coercive isomorphism will occur where the audit committee are formed merely to comply with legislative requirements, and it is expected of municipalities to have audit committees. For example, in local government legislation through the Municipal Systems Act (32 of 2000) (RSA, 2000) and the MFMA (56 of 2003) (RSA, 2003), municipalities are required to appoint independent audit committees. As a result, municipalities could be appointing members that are independent without necessarily considering the environment in which the municipality operates and without necessarily considering the skills and expertise they require. However, the mere existence of an audit committee is not a measure of effectiveness and it cannot measure the value or the contribution the audit committee makes to the council.

Mimetic isomorphism originates from significant environmental uncertainty that results in organisations following practices without necessarily having evidence that these practices are effective. It is done merely to enhance the perception of good governance without considering the industry the organisation operates in (Cohen et al., 2008:186-187). Through mimetic isomorphism in the context of this research may refer to audit committee following practices of other audit committees due to the uncertainty of the specific environment of the municipality at which they serve on the AC.

Normative isomorphism posits involvement through socialisation, for example following best practice guidelines for corporate governance and audit committees. Examples could include academic courses on 'good governance' provided through educational programmes and organisations. In the South African context this could include the activities performed by the Institute of Directors Audit Committee Forum and the Public Sector Audit Committee Forum

as well as guidance documents issued by national and provincial treasury. Organisations then tend to follow best practice guides without questioning the relevancy thereof and the specific application in the culture of the organisation.

It is within this context of corporate governance that the audit committee processes could become similar over time, because organisations are pressured to become similar through regulation, by following what is considered to be best practice or copying other organisations to improve their legitimacy. This type of institutional isomorphism could result in the audit committee playing a ceremonial role only and one of the research questions is to determine if the audit committee merely plays a ceremonial role.

A further suggestion in institutional theory is the tendency to attract homogeneous individuals (Tuttle & Dillard, 2007:394). The effect of this could be that members may come from similar backgrounds and be less inclined to challenge each other or management. The review by Tuttle and Dillard (2007) of isomorphism in accounting research had some similarities with audit committees. Purcell (2012:78) indicates institutional theory also considers that audit committee members are more likely to come from similar backgrounds which may be similar to management. A concern raised by one of the participants during the fieldwork is the occasional over-emphasis on financial expertise within the audit committee. The expertise and experience of audit committee members are further analysed in Chapter 7.

Cohen (2008:190) explains the applicability of the institutional theory to audit committees by referring to one important area of responsibility of the audit committee, to evaluate the effectiveness of internal controls. He explains an audit committee operating under the institutional theory will follow a 'checklist' approach rather than ensuring controls are effective and not being manipulated by management (Cohen, 2008:190).

Regarding both the agency and institutional theories, Wayne (2003:40) concludes that the literature is not clear whether agency theory or institutional theory best defines and describes audit committee effectiveness:

“There is limited support of audit committee effectiveness from an agency perspective; however, there is little empirical research on audit committee effectiveness from an institutional perspective.”

Kalbers and Fogarty (1998:130) discuss differences between the agency theory (see section 2.2.1.1) and the institutional theory specifically related to the oversight of audit committees. According to the researchers the agency theory 'proposes a primarily economic explanation

of the existence and form of control mechanisms' while institutional theory 'offers a sociological approach that questions the sufficiency of technical rationality for understanding corporate governance' (Kalbers & Fogarty, 1998:130). Their review of empirical studies in audit committees reveal that the traditional agency cost measures do not adequately explain the establishment of audit committees and prior studies require a presumption that audit committees are effective in carrying out their responsibilities. According to Kalbers and Fogarty (1998:130) other empirical studies link audit committees' effectiveness to factors internal to corporate governance and the organisation structure without determining the extent to which the internal factors are impacted by external monitoring demands. The results of their research show that neither agency nor institutional theory alone is useful in the assessment of audit committee effectiveness.

Spira (2003:183) identifies the difficulty for shareholders to measure the effectiveness of audit committees performing effective monitoring versus those who only fulfil a ceremonial role due to not having access to the actual meetings.

In the accounting field a limited number of studies have used the institutional theory. Kalbers and Fogarty (1993:36-37), in their research on the effectiveness of audit committees, found a strong association between effectiveness and a strong organisational charter, institutional support through information provision from management and auditors, and a supportive environment by top management and diligence. They conclude that audit committee members operate in an institutionalised environment where they depend on interactions with others to achieve power. In later research on audit committee effectiveness the researchers were unable to proof a strong association between audit committee effectiveness and agency theory factors and suggest further research in the use of both agency theory and institutional theory in the research on audit committees (Kalbers & Fogarty, 1998:145).

Krishnamoorthy, Wright and Cohen (2002:56) report on the auditors' survey completed where 81% of the respondents believe one needs to look at the 'substance' (the actual effectiveness of the AC) and not just the form (complying with regulations) of audit committees to assess whether audit committees are effective.

The tension between the agency theory views of the audit committee as an independent monitor of management versus the institutional theory promoting the audit committee being ceremonial in nature prompted Beasley et al. (2009:66) to conduct a study on the audit committee oversight process through in-depth interviews. Their study examines the question regarding whether audit committees appear to provide substantive oversight of financial

reporting or if they appear to be ceremonial bodies that are designed to create legitimacy (Beasley, 2009:66).

It is considered necessary for understanding audit committee effectiveness to further explore the two theoretical paradigms as part of the detailed research.

Researchers have addressed the challenges with only using the institutional theory in various ways. Spira (1999a:236), in her research on the ceremonial performance of audit committees, considers the institutional theory to explain the use of symbols in seeking legitimacy for the organisation, at the end rather selected actor-network theory<sup>28</sup> as a more appropriate way to explain audit committee activities (1999a:236).

Gendron and Bédard (2006) express the same reservation, stating that audit committees are not empty rituals. They use sociological theories as a basis for their research including processes of self-understandings and understanding of others in constructing meanings around audit committee effectiveness. Rather than assessing if audit committees are effective the objective of the researchers were to better understand the process by which the meaning of audit committee effectiveness are developed and maintained within the small group of people that attend audit committee meetings. Audit committee effectiveness is constructed through four categories of processes including background of audit committee members; ceremonial features of meetings; reflective interpretation of substantive practices during meetings and of informal practices taking place after meetings (Gendron & Bédard, 2006:212). The objective of this study is to determine the practice, practitioners and praxis of effective audit committees and therefore not only examine the structures and type of members serving on the audit committees but also through discussions with the various stakeholders, including the mayor, get an understanding of the processes that impacts on the perceived effectiveness of audit committees. The need for a hybrid of theories that encompass the four categories identified by Gendron and Bédard (2006) was used for this study.

Beasley et al. (2009:70) use a combination of agency theory (audit committees being independent monitors of management) and the institutional theory (viewing audit committees as ceremonial and providing legitimacy through symbols) in their study on the oversight

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<sup>28</sup> Actor-network theory is explained by Brennan and Kirwan (2015:475) as a form of sociological analysis that is associated with the mechanics of power. Spira (1999a:238) states that actor-network theory focuses on the generation of power and influence within and between networks which form and re-form. The purpose of her study, *inter alia*, is to determine the reason for the popularity of audit committees despite the lack of clarity on their purpose and the lack of evidence that audit committees are effective. The purpose is very different from the purpose of this study and therefore the actor-network theory is not considered to be appropriate for this study.



process of audit committees. They state that much of the tension between a substantive and a ceremonial role of the audit committee depends on the attitude of management about governance and monitoring (Beasley et al., 2009:113). The researchers find a wide range of audit committee practices and attitudes as a result of the mix of substantive and ceremonial practices and conclude that agency or institutional theory fully explains the results (Beasley et al., 2009:112) in line with the findings by Kalbers and Fogarty (1998:145) and Nicholson and Kiel (2007:601). Beasley et al. (2009:113) and Kalbers and Fogarty (1998:144) recommend a combination of elements of the agency and institutional theories to promote the understanding of the audit committee and urge for additional theoretical work to examine the role of the AC.

Brennan and Kirwan (2015:475) refer to four studies in their research that used the institutional theory or a hybrid with the institutional theory.

Beattie et al. (2014:320) used some of the dynamics of organisational behavioural literature but viewed audit committees as boundary spanners or gatekeepers – a notion from the resource-dependence theory (see 2.2.1.2). The boundary spanners play two distinctive roles including external representation and information search or processing. External representation refers to the boundary spanner representing the organisation and mediating between the organisation and external organisations to maintain and improve the legitimacy of the organisation. Within the context of audit committees, the audit committee plays a key external representation role to ensure management has an appropriate relationship with the external auditors (refer to section 4.11 of this study). The audit committee can also promote the legitimacy of the organisation to investors and regulators or in the context of this study to the citizens, legislature, and other government departments. On individual boundary spanning Beattie et al. (2014:320) studied the role between the ACC, the CFO, the main board, and the audit partner.

Information search or processing refer to the boundary spanner acting as a filter against environmental information overload and managing the information to be transmitted or disseminated. The ACC also fulfils a gatekeeping role (information access boundary role) to both the audit committee and via the audit committee to the main board in deciding when and the extent of involvement with an issue (Beattie et al., 2014:320). A key reason why audit committees, being a sub-committee of council, exist is to advise council on matters that councillors do not necessarily have the skills and knowledge of for example financial management. How the audit committee and chairperson interact with the council or representatives of the council formed part of this study and is discussed in Chapter 7.



One of the secondary questions of this research is to determine if audit committees provide substantive oversight or merely fulfil a ceremonial role to create legitimacy. For that purpose, the institutional theory is important.

#### *2.2.1.4 Managerial hegemony theory*

The managerial hegemony theory views the board and the committees of the board to be under the control of management and exists merely to fulfil regulatory requirements (Cohen, et al., 2008:182; Kosnik, 1987:166). With the managerial hegemony theory, it is argued that senior management appoints colleagues or acquaintances that will not restrict management and be passive as part of the governance processes (Kosnik, 1987:167). According to the theory, directors and the audit committee are dependent upon management for information and the outcome is more of a symbolic compliance by the audit committee rather than oversight of management as per the agency theory.

Cohen et al. (2008:186) analysed the managerial hegemony theory by referring to the work of Westphal and Zajac (1998) and Beatty and Zajac (1994), being examples of the lack of independent monitoring by the board of directors and the negative impact on corporate governance. Beatty and Zajac in their 1994 study found that many firms announce new long-term incentive plans but do not implement this mainly as a result of the chief executive officer having a greater influence over the policy than the influence of the board. Their results suggest that the chief executive officer buckles under external pressure for greater incentive alignment, but only symbolically, but at the same time minimise the actual compensation risk as part of the incentive packages. In the 1998 study, Westphal and Zajac (1998:127) examined the consequences of symbolic action in corporate governance and found symbolic corporate actions can lead to significant positive shareholder reaction and discourage more substantive governance reforms to be implemented and thereby perpetuating power imbalances in organisations.

Although the paying of incentives do not necessarily play a role in the public sector audit committees might be appointed as a result of external pressures and influenced by management and thereby creating the 'symbol' with a positive reaction by stakeholders without management necessarily taking the advice of audit committees into consideration. External pressures in the South African local government context can include both the AGSA and national and provincial Treasury departments. The AGSA, as part of its audit, investigate governance and report on shortcomings in audit committees. National and provincial Treasury

also oversees governance and the implementation thereof that could result in audit committees being appointed to comply with the external pressures.

Kosnik (1987:169) argues the agency and the managerial hegemony theory both focus on the relationship between the governing body (board), management, and the shareholders; both assume control problems will result in conflict of interest between management and the shareholders in that management behaviour will result in negative consequences to the shareholders. However, the difference between the two theories is in the area of governing performance is that the agency theory emphasises the effective governing potential of the board while the managerial hegemony theory rejects the directors as an effective governance force.

The implication of the managerial hegemony theory from the perspective of the effectiveness of audit committees is that members of the AC, if appointed by colleagues or acquaintances, will be under the control of management and less likely to ask probing questions or be critical of management. It could further have consequences in disputes between external audit and management pertaining to financial statements in that the audit committee members could tend to side with management rather than external audit.

Table 2.1 below reflects a comparative evaluation of the agency, resource dependence, managerial hegemony, and institutional theories as summarised by Cohen et al. (2008:189).

During the fieldwork, the appointment, appointment process, and possibility of management influencing the appointment of audit committee members was determined, which is further explored and addressed in Chapter 7.

If the legislative requirement (section 166 of the MFMA) of advising the council and the guidelines of circular 65 is considered and applied to the summary in Table 2.1 both the agency and resource dependence perspectives are relevant for this study.

**Table 2.1: Comparative evaluation of agency, resource dependence, managerial hegemony, and institutional theories**

	Agency	Resource dependence	Managerial hegemony	Institutional theory
<b>Selection of board members</b>	Primarily by stockholders.	By stockholder and/or management.	Primarily by management.	Primarily by management.
<b>Primary board member attributes</b>	Independence, and expertise in monitoring and control.	Industry expertise, expertise in helping to set corporate strategy, and providing access to external networks.	Independence in 'form' but not in 'substance'.	Perceived knowledge and independence. Frequent meetings.
<b>Primary focus of the board</b>	Monitoring management's actions.	Aiding management in setting corporate strategy.	Board consisting of 'cronies' of management who will meet external requirements.	To provide assurance to outsiders that information provided by management is legitimate.
<b>Other board foci</b>	Corporate performance; Global risk management; CEO and management compensation; Monitoring and control.	Helping management execute the business model, strategic plans and managing business risk.	Enhancing senior management compensation.	Enhancing legitimacy of financial reporting process.
<b>Importance of the audit committee in ensuring a high-quality financial reporting process</b>	Highest	Indeterminate	Lowest	Indeterminate
<b>Role of the auditor</b>	Independent party working with other governance parties to ensure sound financial reporting.	Auditor plays key role in independently ensuring sound financial reporting. Little or no role in assisting the company to achieve operational goals and strategies.	With governance under management's control, the auditor is the sole independent party responsible for sound financial reporting.	With the audit committee and board symbolic, the auditor is heavily responsible for sound financial reporting.

(Cohen, Krishnamoorthy &amp; Wright, 2008:189).

Beasley et al. (2009: 70) summarises the differences between the different theories as follows: "... agency theory emphasises directors as independent, vigilant monitor of management; institutional theory emphasises the symbolic/ceremonial role of governance structures where legitimacy is paramount and formal processes are only loosely coupled with true monitoring; resource dependence theory focuses on the board's efforts to assist management with strategy and resources; ...and managerial hegemony asserts the audit committee will be weak and under management's control."

Another theoretical perspective that has gained momentum in research on boards and audit committees is the practice theory that is analysed in the next section.

### *2.2.1.5 Practice theory*

The practice perspective was developed in social theory and other management disciplines and fields including technology, learning at work, institutional change, marketing, and accounting (Whittington, 2006:613-616). Whittington identifies three core themes for practice theory: the first refers to society and the interest of practice theorists on how social systems define the practices including shared understandings, cultural rules, languages, and procedures that guide the human activity. The second refers to the actual activity in practice and not only being interested in *what* is done but *how* it is done. The third theme refers to the actors on whose skills and initiative activity depends (Whittington, 2006:615).

Turley and Zaman (2004:324), in their earlier synthesis and evaluation of empirical research on the governance effects associated with audit committees, conclude as follows:

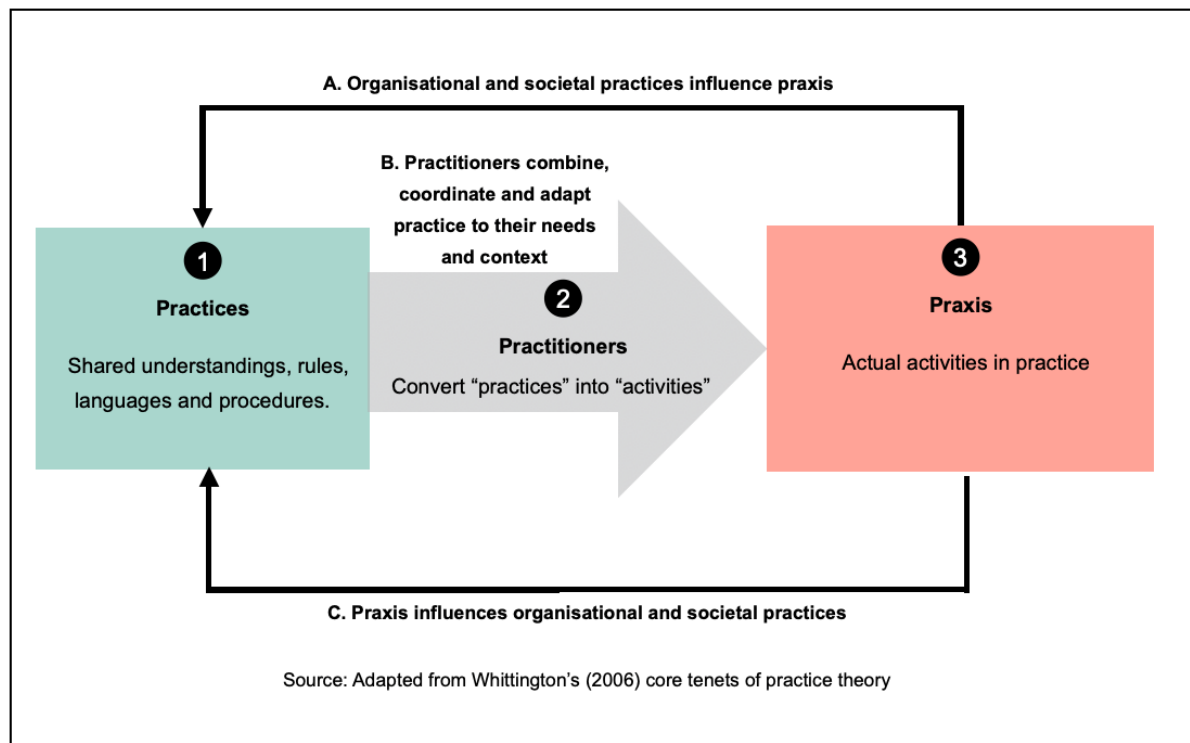
"Policy on audit committees has tended to emphasise characteristics of the committee and its members, but the processes through which the audit committees activities are conducted and the impact on other organizational processes and the behaviour of other participants are of at least equal importance."

Whittington (2006:613) in his research on strategy proposes a framework that integrates the intra-organisational and extra-organisational levels based on the concepts of strategy praxis, strategy practices and strategy practitioners. Practices include the organisation and their wider social fields, the actual activity is termed praxis and the actors are the strategy practitioners that are all interrelated (Whittington, 2006:613). According to Whittington:

"Following practice theory in general, practitioners are seen as the critical connection between intra-organizational praxis and the organizational and extra-organizational practices that they rely on in this praxis. Practitioners' reliance on these practices is not simply passive, however.

Praxis is an artful and improvisatory performance. ...practitioners also have the possibility of changing the ingredients of their praxis. By reflecting on experience, practitioners are able to adapt existing practices; by exploring plurality, they are sometimes able to synthesise new practices; by taking advantage of openness, they may be able to introduce new practitioners and new practices altogether" (2006:620).

The following figure adapted from Whittington by Brennan and Kirwan (2015:469) demonstrates the relationship between practices, practitioners, and praxis.



**Figure 2.2. The relationship between practices, practitioners, and praxis**

A similar approach is used for this research. Through the interviews and interactions with the ACC, mayor, MM, CFO, and CAE this research includes the intra-organisational and extra-organisational levels based on the concepts of strategy praxis, practices and practitioners referred to by Whittington (Whittington, 2006:613). The research specifically includes the practice, the practitioners, and the actual activities (praxis) that are all interrelated.

The more recent studies reflected on below, answers the calls for more practice-oriented<sup>29</sup> research. Smallman (2007:245) in his argument recognises the gap between best practice theory and implementation and states 'bad theory is very definitely destroying good practice'. According to him, a processual approach acknowledges that corporate governance practice

<sup>29</sup> Roberts (2005:250); Smallman (2007:246); Turley and Zaman (2007:766), and Whittington (2011:184).

around the world continues to develop in different and unique cultural, historical, and social circumstances (Smallman, 2007:242). He states that context is critical and in accounting for governance it is important to consider the influence of politics, culture, economics, and the natural environment (Smallman, 2007:243). In light of the complexity he underscores the necessity to understand the practice of governance and the processes that comprise this practice. He urges governance researchers to seek deeper and more meaningful evidence to inform and improve governance practice (Smallman, 2007:246). This call from Smallman supports a practice-theory approach.

In 2009, Gendron (2009:123) identified the need for qualitative research studies to be able to understand governance processes in action. This was echoed by Ghafran and O'Sullivan (2013:400) and Ahrens, Filatotchev, and Thomsen (2011:323), who also identified the need for more field studies of corporate governance practices and the interactions between corporate governance practitioners.

Feldman and Orlikowski (2011:1241) acknowledge that there is no widely accepted definition for practice theory. Brennan and Kirwan (2015) base their framework of practice theory on the three components of practice theory i.e. practice, practitioners, and praxis promoted by (Jarzabkowski, Balogun, & Seidl, 2007:7) and Whittington (2006:613). Practices refer to shared understandings, rules, languages, and procedures or often referred to as 'best practice' (Brennan & Kirwan, 2015:468). Practitioners take the practices and use their own skills and initiatives to convert practices into activities (praxis), so practices inform praxis (Ahrens et al., 2011:318). The praxis therefore is created by human actions and can as a result be changed and improved (Scherer & Palazzo, 2007:1104). Jarzabkowski et al. (2007:9) describe praxis as follows:

"...it unfolds as the nexus of what is going on in society and what people are doing. Praxis comprises the interconnection between the actions of different, dispersed individuals and groups and those socially, politically, and economically embedded institutions within which individuals act and to which they contribute."

Practitioners are the main element of practice theory. In the corporate governance sphere the corporate governance activities in practice (praxis) are influenced by societal (outside organisation), regulatory and organisational (within the organisation – procedures and cultures) factors. For example, the corporate governance activities of the board in practice are influenced by norms and expectations of best practices, but at the same time are influenced by the practitioners' interpretation and internalisation of practices. Ahrens et al. (2011:318) agree and suggest corporate governance legislation, rules, and standards must be considered

as part of the resources of practice that are used and adapted by practitioners. Practitioners are those individuals that draw upon practices to act and are interrelated with praxis and practice (Jarzabkowski et al., 2007:10).

Throughout this study the researcher also shares stories and experiences as a practitioner in practice while serving on audit committees and as ACC in line with the practice theory promoted by the different researchers. As part of the learning process and to develop true expertise the researcher was motivated to write stories as a practitioner.

Related to audit committees, Brennan and Kirwan (2015:476-477) recognise that most prior research on audit committees focusses on the structural arrangement of audit committees and not on the interaction with other role-players such as management, internal, and external auditors and other processes that can affect the effectiveness or lack thereof, prompting their further research in the use of practice theory. They propose using a corporate-governance-as-practice approach that has the advantage of humanising corporate governance research and study the socially defined macro-practices and numerous micro-practices that practitioners can use to shape organisational activities (Brennan and Kirwan, 2015:476-477).

In recent research on audit committees, Brennan and Kirwan (2015) apply the practice theory as an alternative theory over the dominating 'input-output studies' of audit committees to provide alternative insights into the key governance mechanism, being audit committees. Similar to other criticism on research of audit committees they are of the opinion research fails to recognise the dynamic, interactive nature of governance and recognise the need to capture real world situations (Brennan and Kirwan, 2015:466). Their views are supported by McNulty et al. (2013:183) and Whittington (2011:184). According to Brennan and Kirwan (2015:468), the practice theory focuses on the dynamic relationship and interactions between processes and outcomes. Brennan and Kirwan (2015: 476) conclude, based on archival studies alone, that it is difficult to assess whether governance is only a ritual or if audit committees are in fact very active in the execution of their duties. Only by using more practice-orientated research through the examination of practice, practitioners, and praxis of audit committees will the assessment be able to be done.

Brennan and Kirwan (2015:471, 480) recognise over and above the focus on the structures of audit committees, research also focus on the compliance with practice and the agency theory and an attempt to find causal linkages without a full understanding of the governance processes that might explain the research findings. The role of the audit committee is mostly conceptualised as a singular function being 'monitoring' and is studied at a distance from the

phenomena. They acknowledge that few studies examine audit committees from a practice perspective. They also recognise the opportunity for understanding what happens within the important governance mechanisms of the AC, an area which has been explored minimally when compared with research on boards of directors (Brennan and Kirwan, 2015:480).

Brennan and Kirwan (2015:481) conclude:

“...practice-theory represents a framework for developing a holistic view of audit committees’ role in corporate governance practice. Practice theory encourages us to incorporate the *status quo* practices that underpin corporate governance practice, while recognising that effective corporate governance ‘in practice’ is fluid, context specific and dependent on practitioners’ skills, initiative and adaptation.”

However, selecting one specific theory as part of corporate governance research can limit the knowledge generation. Daily et al. (2003:372) reflect on this and make the following statement: “...parts of the governance literature stem from a wider range of theoretical perspectives. Many of these theoretical perspectives are intended as complements to – not substitutes for – agency theory. A multitheoretic approach to corporate governance is essential for recognizing the many mechanisms and structures that might reasonably enhance organizational functioning.”

Jarzabkowski et al. (2007:19) agree and observe that a research field may not necessarily require new theories but can use a combination of existing theories to explain interactions between and consequences of practice, practitioners, and praxis. Practice, practitioners, and praxis are used to categorise the different studies on audit committee effectiveness in section 2.2.3.

Cohen et al. conclude on the applicability of the different theories as follows:

“The importance and effectiveness of the audit committee in the governance process is likely to vary based on the organizational perspective driving the governance processes. The importance of outside, independent board members will be greater in a governance structure where the agency perspective dominates, and monitoring is emphasized. ...an institutional theory perspective suggests that the AC’s role is primarily symbolic and ritualistic and likewise leads to indeterminate predictions, as it cannot by definition be decoupled from the institutional context of the organization” (2008:188).

Cohen et al. (2008:194) recommend three alternative theoretical perspectives that offer useful insights for accounting and auditing researchers involved in investigations of corporate



governance, being the resource dependence (strategic perspective), managerial hegemony (entrenchment perspective), and institutional theory (legitimate perspective).

Cohen et al. (2008:183) claim that as far as they are aware it is the first paper that studies the insights of using alternative theories of governance on accounting/auditing issues although the importance of using other theories of governance on accounting/auditing issues have been recognised by researchers outside accounting/auditing. In 1989, Eisenhardt already recommended combining agency theory with complementary theories (1989:71).

According to Smallman (2007:242), 'research in corporate governance requires an approach that will clarify similarities and differences among theories, to facilitate theoretical integration, and to generate a comprehensive understanding of governance'.

Within the context of this research on audit committees in local government with a legal requirement to advise council and management it becomes clear that all five theoretical perspectives could have relevance for this study. From an agency perspective the audit committee must be independent and have a key monitoring role to play and report to council. As a result of the emphasis on legislative compliance and the emphasis on governance by various role-players including the Auditor-General the institutional theory can also apply in that audit committees are appointed merely to comply without true monitoring taking place. If the extent and complexity of the roles and responsibilities of audit committees in local government are considered and the resources audit committees bring to the table to assist council in performing the duties of ensuring quality financial reporting, sound internal controls, effective risk management and governance the resource dependence theory is also relevant. Only once the appointment process is further analysed during the fieldwork the relevancy of the managerial hegemony perspective can be concluded on. As a result of the continuous development in corporate governance in different unique cultural, historical, economical, and natural environments, the call in recent research is to understand the processes and interactions between corporate governance practitioners through a practice-orientated approach. The applicability and use of a combination of or hybrid of theoretical perspectives are considered in the next two sections.

### *2.2.1.6 Hybrid – resource dependence and agency theories*

Hillman and Dalziel (2003: 383) I, in their analysis of the performance of the firm and directors, recognise that the board of directors has two purposes: to provide resources and monitor management and therefore warrants a hybrid of resource dependency theory and agency

theory instead of trying to frame the research in either agency or resource dependency theories. Carpenter and Westphal (2001:641) and Westphal (1999:7) find empirical evidence that supports the differentiation between the monitoring and resource provision.

Cohen et al. (2008:188) promote the benefits of using different theories. As part of the research they examine three areas: 1) the evaluation of internal controls; 2) financial distress and auditors' going-concern opinions; and 3) governance and the audit process. According to the agency theory an auditor would focus on control activities including the independence and expertise of the audit committee in ensuring sound financial reporting while under the resource dependence theory the auditor would focus on the company's mechanism to develop sound strategies and control business risks. Under the institutional theory the auditor would focus on evaluating whether formal measures are in place to ensure compliance with laws and regulations including independence of audit committee members, expertise, and meeting frequency. However, the danger of this is that the auditor may focus excessively on form over substance. The audit committee might meet all the requirements (form) but are not necessarily diligent nor confront management to ensure high-quality financial reporting (Cohen et al., 2008:190). If different theories are combined there would not be an overemphasis on one specific component.

Hillman and Dalziel (2003:383) argue that in practice, boards monitor and provide resources and, theoretically both are related to firm performance, and conclude to integrate agency and resource dependence perspectives is important. They state that agency theorists and resource dependence theorists have examined either monitoring or the provision of resources contributing to an incomplete understanding of the role of the board, how it affects an organisation's performance, and what contributes to the provision of resources and effective monitoring. They also argue that the incentives of the board moderate the relationship between the board capital and monitoring/provision of resources. The agency theory only focuses on incentives to monitor and ignores the board's ability to monitor (Hillman & Dalziel, 2003:383). Seawright (2015:2), in his research on the association between audit committee directors' political skill and audit committee quality and effectiveness, used a hybrid of resource dependency theory and agency theory to study the association between audit committee directors' political skill and audit committee diligence.

Agency, on the one hand and indicated above, has been the dominant theory used and describes a key activity of the board to monitor management on behalf of the shareholders. The resource dependency theory, which is less explored, examines the relationship between the board as a provider of resources (legitimacy, advice and counsel, and links to other

organisations) and firm performance (Hillman & Dalziel, 2003:383). According to Hillman and Dalziel (2003:384), agency theorists focus on the incentive of boards to monitor but ignore the board's capital resulting in a lack of understanding of effective monitoring.

The hybrid approach is considered relevant for further exploration due to the advisory role the audit committee needs to play according to the local government legislative requirements for audit committees in South Africa. Specifically, the advisory versus monitoring role is described in Chapter 4. Cohen et al. (2008:194) support the need for future studies to examine audit committee characteristics by using a hybrid resource dependency theory and agency theory approach as well as other theories including managerial hegemony and institutional theory.

#### *2.2.1.7 Hybrid – agency and institutional theories*

Wayne (2003:85) developed an audit committee effectiveness matrix by using the principles of agency theory, institutional theory, trust, and scepticism. By using the elements of agency (substantive approach to oversight) and institutional theories (symbolic approach) he also included the sceptical view of the environment supported by the agency theory versus the element of trust on which the institutional theory is based (Wayne, 2003:85). The consolidation of the agency and institutional theory resulted in Wayne identifying four different approaches the audit committee can use to fulfil their functional responsibilities and the statutory obligations. According to his research the audit committee can be positioned in four quadrants of the matrix developed being a 'paralysed' AC, an 'institutional' AC, a 'professional' AC, and an 'agency' AC, and this was critical to understand the barriers and conditions for effectiveness (Wayne, 2003:86). The four quadrants and the applicability and use in this study is further unpacked in section 2.2.3.

Research by Kalbers and Fogarty (1998:140) on audit committee oversight used a combination of institutional and agency theory to assess effectiveness of audit committees. They used six constructs for audit committee power of which three are institutionally based by way of organisational policies and actions and three are individually based powers, using the data set of their earlier 1993 study. The three institutionally-based powers include legitimate power, sanctionary power, and institutional support and the effectiveness of audit committees are measured in the areas of financial reporting, annual audit and external auditors, internal controls and internal auditors, and an overall effectiveness rating (Kalbers and Fogarty, 1998:139). Sanctionary power<sup>30</sup> includes the perceived level of AC's responsibility to

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<sup>30</sup> Also described in Kalbers and Fogarty as the ability to manipulate rewards and punishments to achieve desired goals (1993:28).

determine the budgets and compensation of internal auditors and to determine the scope and compensation of external auditors. Legitimate power includes the existence and perceived adequacy of written authority of the AC, as well as its general authority and importance. Institutional support includes timeliness, usefulness and reliability of information provided by the chief executive officer, CFO, chief internal auditor and external auditors; perceived supportive tone of top management, and perceived working relationship between the AC, chief executive officer, CFO, chief internal auditor, and external auditors (Kalbers and Fogarty, 1998:140). The researchers conclude that audit committee effectiveness emanates from the sources close to the actual functioning of the audit committee, supporting the methodology used in this research (Kalbers & Fogarty, 1998:144).

### **2.2.2 Conclusion on selected theoretical basis**

The above analysis of the possible use of different theories, including a hybrid of theories, indicates the values and shortcomings of the different theories applied in practice. Theories, other than agency theory only, and a hybrid of theories can counter the shortcomings, and as indicated by Cohen et al. (2008:183), may be useful for reconciling conflicting findings in the existing agency-based audit-related governance literature.

The study by Turley and Zaman (2007:783) and the results also indicate the usefulness of following a hybrid of theories in the examination of audit committee effectiveness. By following a case study approach the researchers identified four significant factors that affects the contribution made by audit committees to governance outcomes that would otherwise not have been identified by way of theorisation or development of policy. Related to the influence on power relations between stakeholders in the organisation the research found the committee play various roles including acting as an ally, arbiter and sometimes being used as a threat to support the authority of other organisational participants (Turley and Zaman, 2007:783).

Zaman and Sarens (2013:511-512) also promote the use of multi-theory and multi-method approaches in future research on audit committees and the interaction with others involved in the governance process in different institutional and cultural contexts.

Specifically, when the complexity of the local government environment is considered the use of a hybrid theoretical model could provide new insights into the research on the effectiveness of audit committees.

One of the few studies on the effectiveness of audit committees in local government, completed for a municipality in Australia recognises a variety of negative and positive behaviours that are consistent with agency, resource dependence, power, and institutional theories (Purcell et al., 2014: 339). The study is further analysed in section 2.2.3.

This point of view that calls for theoretical pluralism in the study of audit committees and through qualitative inquiries endeavour to comprehend corporate governance processes in action was also raised by Gendron (2009:123).

McNulty et al. (2013:191) identify a variety of theoretical perspectives used in research on boards in their review of qualitative corporate governance research. Brennan and Kirwan (2015:475) perceive the benefit in the variety of theoretical perspectives used, stating that it opens 'fruitful avenues for researching audit committees'.

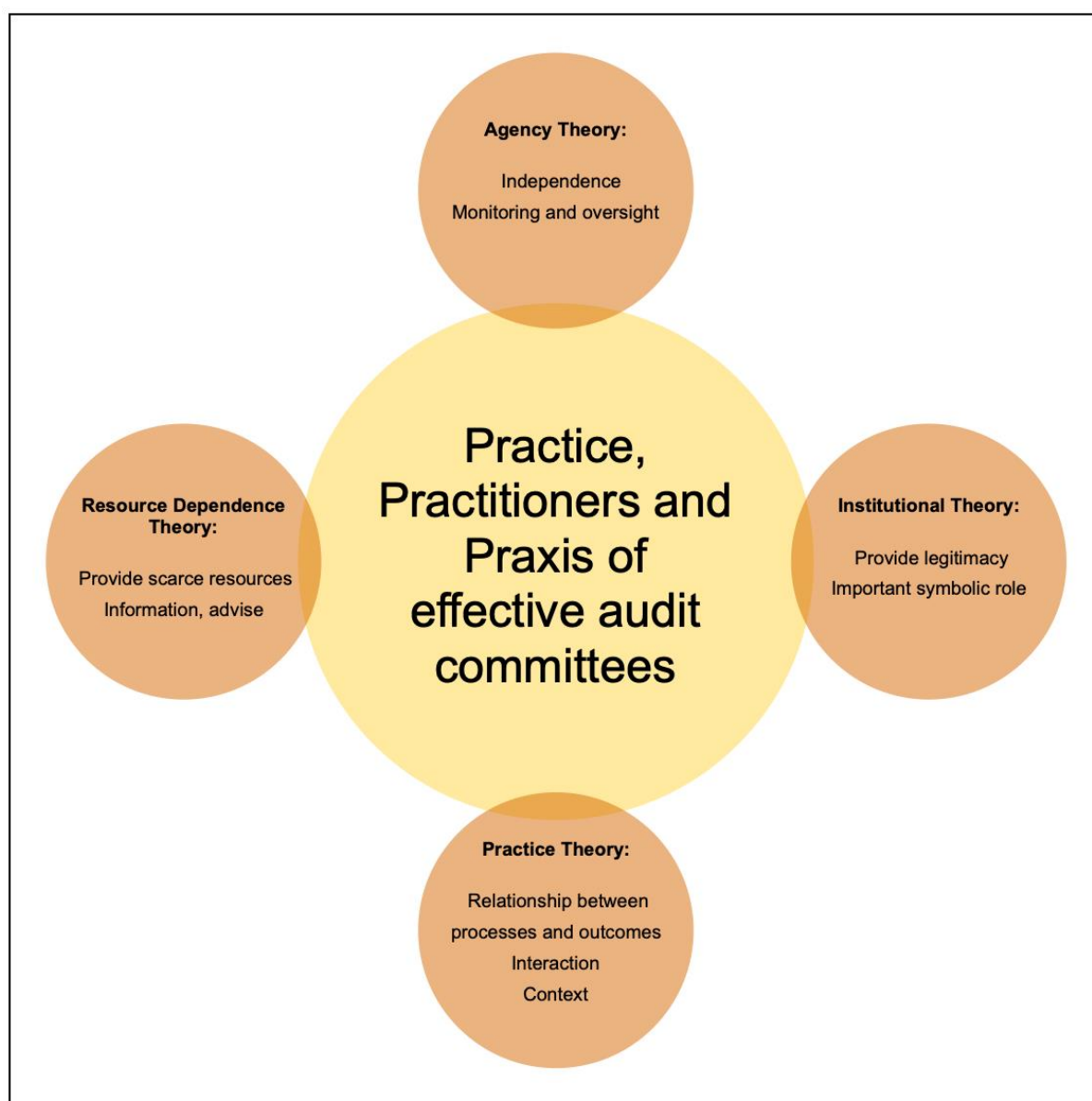
Trafford and Leshem (2008:79-80) suggest that the theoretical perspective is a combination of theories on the research topic and methodologies through demonstrating the gap in the literature on the area being researched; delimiting the research with justification; developing conceptual paradigms as frameworks in which to design the research; creating the conceptual frameworks to determine how the research is designed, analysed and concluded; giving theoretical authority to the decisions during the research process; and justifying the conceptualising of conclusions as contributing to knowledge within the specific parameters of a gap in knowledge.

The literature on theoretical perspectives that can and should be used indicated in the context of audit committees' multiple-theoretical frameworks in accordance with the statement by Trafford and Leshem (2008). Figure 2.3 demonstrates how the four theories are used in this research on the practice, practitioners, and praxis of effective audit committees.

Carcello et al. (2011:19) make the following statement in this regard:

"In terms of theory development, most governance research is based on the agency theory. However, there are multiple theories of governance – e.g., resource dependence theory (the board's main role is to assist management in securing key organizational resources), institutional theory (governance mechanisms may be somewhat ceremonial, designed to enhance external legitimacy but loosely coupled with actual oversight), and managerial hegemony theory (board members are friends and cronies of management)...One research area where multiple theoretical perspectives have been used relates to audit committees' processes..."

Researchers often find that audit committee members interviewed about governance processes provide responses that are consistent with a mix of governance theories.

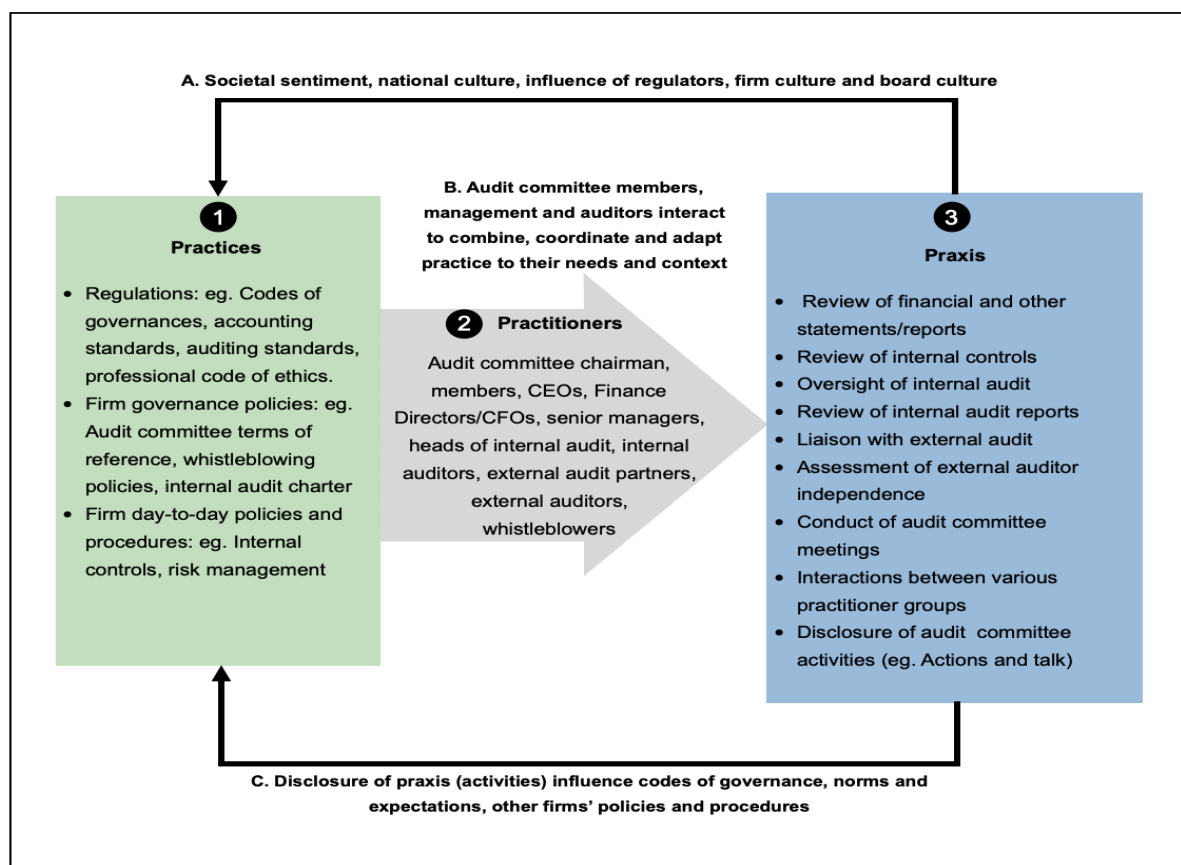


**Figure 2.3. Combination of theories to be used in the study on practice, practitioners, and praxis of effective audit committees in local government**

### **2.2.3 Analysis of audit committee effectiveness studies**

Brennan and Kirwan (2015:467) categorise research on audit committees in three areas namely practices; practitioners and praxis. Although not all research on audit committees belongs to only one of the categories, the categorisation proved to be useful to present the literature on audit committee effectiveness. Practices include rules and procedures,

practitioners convert practices into activities and comprise of audit committees and other governance practitioners, and praxis refers to the actual activities in practice. Practitioners combine and adapt practice to their needs and context and apply it in practice. Practice implies the status quo, while praxis suggests bringing theory and practice together with a view to change and improve practice (Brennan and Kirwan, 2015:481). The figure below depicts the practice-theory analytical framework customised for audit committees.



**Figure 2.4. Practice-theory analytical framework customised for audit committees** (Brennan & Kirwan, 2015:470).

Brennan and Kirwan (2015:469-470) equate practices to social norms and rules and best practice and found this to be the dominant category of research on audit committees, rather than focussing on the interaction with other role-players including management, internal audit and external audit, and other processes that could affect the effectiveness or ineffectiveness. In light of the emphasis on best practice the section of this study's literature review starts with reflecting on research of practices of audit committees, followed by practitioners, and then praxis.



### 2.2.3.1 *Audit committee practices*

Whittington (2006:619) explains that practices may refer to shared routines of behaviour including traditions, norms, and procedures, including performing activities and using resources. Brennan and Kirwan (2015:468) explain that practices include shared understandings, rules, languages, and procedures that guide and enable humans to perform activities and is also referred to as 'best practice'.

A review of the audit committee literature by Purcell (2012:62) revealed a number of research articles that had a compliance and regulatory perspective to audit committee effectiveness, also confirmed by Bédard and Gendron (2010:175). A typical research study on audit committee practices is that of Böhm, Bollen and Hassink (2016:128), which analysed the code of governance related to audit committees and the audit committee charters<sup>31</sup> in Australia, the United Kingdom, United States, and six European countries. They found significant cross-national differences concluding the practices are not standardised across jurisdictions. The audit committee charters of the municipalities forming part of this research were also analysed and the results are discussed in section 7.4.1.1.

The researcher identified during the literature review of audit committee practices that broad thematic areas included existence and composition (independence and expertise) of audit committees; ceremonial role versus substantive monitoring; interaction and relationship between the audit committee and other role-players specifically internal and external audit and the call for research into audit committees to take the specific organisational context into consideration. The literature on the themes are further discussed in the section. However, due to research studies including elements of practice, practitioners, and praxis some of the themes are further elaborated on in the next two sections of the literature review as well as in the relevant sections of this study.

As recognised by researchers it is difficult to measure audit committee effectiveness. Spangler and Braiotta (1990:152) identified the difficulty in objective measures of effectiveness and used subjective measures of effectiveness<sup>32</sup>. Gendron et al.(2004:155) warn that studies and research into the effectiveness of audit committees need to be interpreted with care as a measurement of effectiveness is a multidimensional notion that is difficult to measure. Examples provided by the researchers are that effectiveness is measured by subjective

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<sup>31</sup> Audit committee charters are discussed in section 4.5 of this study.

<sup>32</sup> Measures included effective use of the time and expertise of the independent auditor and the firm's internal auditors, motivation of senior management to undertake changes in policies and procedures, handling of fraudulent or illegal acts, prevention of future illegal acts, and overall effectiveness of the audit committee.



measures (such as deficiencies in financial statements) or proxies (such as discretionary accruals and analysis) being restricted to the link between externally observable features of audit committees and indicators of effectiveness without considering activities performed by audit committee members (Gendron et al., 2004:155).

In the first thematic area of existence and composition of audit committees, in their examination of financial statement fraud instances and the relationship with governance mechanisms, Beasley et al. (2000:441) found that fraudulent companies in all three industries investigated were less likely to have independent audit committees, outsiders on the board, and an internal audit function (IAF).

In the second thematic area of ceremonial role versus substantive monitoring, Spira (1999a:231) decided to explore qualitatively (one of the first qualitative studies into audit committee activities) the role of the audit committee through the stories of audit committee participants (ACCs and members, finance directors, and internal and external auditors) focusing on the ceremonial performance of audit committees. At that stage empirical evidence on audit committees was limited. She focuses on the ceremonial nature of audit committee activities and the important role the audit committee play to provide comfort and reassurance to investors and lenders (Spira, 1999a:231). The paper suggested a possible explanation for the popularity of audit committees without evidence of their effectiveness may be as a result of the ceremonial function that validates the legitimacy of the institution and enables access to resources for survival through a 'display' of concern for corporate governance standards (Spira, 1999a:231).

Spira (1999b:262) also examines independence and the results suggest that audit committees' display of independence forms part of the ceremonial role that creates confidence in the corporate governance mechanisms.

The possible ceremonial role audit committees play is investigated as part of this research study, and one of the research objectives is to determine whether the audit committee provides substantive oversight or merely play a ceremonial role to create legitimacy. In local government in South Africa, and as a result of the appointment of audit committees being a legislative requirement, the possibility exists that audit committees are appointed to comply with the requirements of the MFMA (56 of 2003) (RSA, 2003) and therefore play a ceremonial role rather than providing substantive oversight and advice. This study researched this phenomenon through the interviews with the different role-players and the perception of the actual value-added by the audit committees and is discussed in Chapter 7.

In the third thematic area of interaction and relationship between the audit committee and other role-players, specifically internal and external auditors, one of the earliest studies on audit committee practices is the research by Goodwin and Yeo (2001). They conducted a survey with 65 chief internal auditors in Singapore and found a strong working relationship and communication between audit committees and internal audits. They found that the interaction was greater when the audit committee comprised of independent directors. They also concluded that independent audit committee members met more frequently with internal auditors than those that were not independent (Goodwin & Yeo, 2001:107). The composition of audit committees is further discussed in section 5.5 of this study.

Zain and Subramaniam (2007:894) completed a study in Malaysia on internal auditor's perceptions of their interactions with audit committee members. The results indicate infrequent informal communications, limited private meetings, and the need for clear reporting lines. It is further indicated that audit committees are held in high regard for their authority and are expected to take on great leadership in the review of management decision-making (Zain & Subramaniam, 2007:894).

In the interaction between the audit committee and external audit, Cohen et al. (2002:573) conducted semi-structured interviews with 36 auditors to determine the influence of corporate governance on the audit process, including the role played by the AC. They found that auditors perceive management to be the primary driver of corporate governance (Cohen et al., 2002:573). The auditors also indicated they met regularly with audit committees and discussed the audit plan and the results of the audit. Some of the audit partners (one-third) indicated they also discussed disagreements they have with management with the AC. However, several respondents stated that audit committees often lacked expertise to be effective. The lack of expertise of audit committee members, for example in financial matters, resulted in basic questions being asked and audit committee members not being able to resolve contentious issues with management. The auditors describe audit committee meetings and their interactions with the audit committee consisting of the auditor reporting on significant issues and not being an active two-way exchange or proactive participation by the audit committee (Cohen et al., 2002:586).

Gendron et al. (2004:154), by way of a field study, examined the practices carried out in audit committee meetings for three Canadian public corporations by interviewing nine audit committee members and 13 other individuals including the chief executive officer, CFO, internal auditor, and external auditor. The audit committees selected complied to a large extent

with the regulatory guidelines and the voluntary recommendations of the Blue Ribbon Committee (BRC) on Audit Committee effectiveness. The research questions included: (1) what matters are emphasised in audit committee meetings by the members; (2) how members evaluate these matters; and (3) how members assess responses and comments made by management and auditors during meetings (Gendron et al., 2004:154). Gendron et al. found that key matters audit committee members focus on during meetings are financial statement accuracy and appropriate wording in financial reports, effectiveness of internal controls, and quality of work performed by auditors. They concluded that those practices that make audit committees comfortable included the accuracy of financial statements and quality of work performed by auditors. The study reveals meetings are much more than formal rituals for managers and auditors but rather the platform where managers and auditors have to demonstrate to the audit committee their trust worthiness measured by the consistency of responses provided by the different parties, and that credibility is developed over time with regard to the validity of previous answers. The key role of the audit committee is to ask challenging questions of management and auditors (Gedron et al., 2004:168-169).

Another example of a study on practices is the research completed by Beattie, Fearnley and Hines (2013). The researchers used the information obtained from a 2007 survey of United Kingdom listed companies' CFOs, ACCs and audit partners that obtained views on the impact of 36 economic and regulatory factors on audit quality post Sarbanes Oxley implementation. Of the 36 factors, seven related to audit committees including independence, financial expertise, and personal reputation. All respondent groups rated various audit committee interactions with auditors among the factors most enhancing audit quality (Beattie et al., 2013:56). Through exploratory factor analysis the original set of 36 factors were reduced to nine independent dimensions, of which audit committee activities as a dimension was reinforced. The CFOs viewed audit committee activities as two-dimensional and including approvals and recommendations in relation to the auditor and audit quality monitoring (Beattie et al., 2013:77). In the South African public sector context, and explained in section 4.11, the audit committee plays a limited role in approvals of activities of the Auditor-General or the monitoring of audit quality. During the fieldwork, participants expressed concern and frustration in this regard, which is further discussed in Chapter 7.

In the last thematic area on practices of audit committees in the organisational context, Gendron et al. (2004:169) study the audit committee activity within the specific organisational contexts and specifically what happens inside audit committee meetings in their field study on the practices of effective audit committees. Data is collected mainly by way of in-depth

interviews that provide them with a rich database and significant patterns across interviewees' transcripts (Gedron et al., 2004:169).

Bédard and Gendron (2010:174) examined academic research on audit committee effectiveness in a large set of academic journals – the majority being accounting journals - from 1994 to 2008 and investigated the results of studies that examined the relationship between audit committee characteristics and measures of audit committee effectiveness. They report that a significant proportion of the studies found a positive association between effectiveness and the presence of the AC, independence of audit committees, and the competencies of audit committee members. They further found the number of meetings and the size of the committee are not often positively associated with audit committee effectiveness (Bédard and Gendron, 2010:174). Their review of literature differs from that of Turley and Zaman (2010:176) (international comparisons) in that it is a more systematic analysis of the association between audit committee characteristics and wide-ranging indicators of effectiveness that was grouped into information quality, audit quality, internal control effectiveness and investor' perceptions of these dimensions. They report inconsistencies in research results but conclude it is not surprising due to the complexity of studying audit committee effectiveness and the variety of factors influencing the effectiveness including group dynamics and cultural beliefs and practices (Turley and Zaman, 2010:176).

Beasley et al. (2009:77-78), in the review of the audit committee oversight processes, identified six process areas based on best practices, experience, academic and professional literature, and discussion with different role-players. The identified audit committee process areas include acceptance and due diligence to serve on audit committees, selection of audit committee nominees, audit committee meeting processes, oversight of financial reporting processes, oversight of internal and external audit processes, and other audit committee activities (Beasley et al., 2009:77-78). Information about the audit committee process was obtained through in-depth interviews with 42 individuals actively serving on audit committees. Beasley et al. (2009: 66) found that many audit committees endeavour to provide effective monitoring of financial reporting rather than serving on ceremonial audit committees. Within the six audit committee process areas they found evidence of both substantive monitoring and ceremonial actions that the agency theory or institutional theory could not properly explain. They also found many responses vary with personal and company characteristics (Beasley et al., 2009: 66). In comparison with the framework of Cohen et al. (2004:89) which studied the central parties in the corporate governance framework to include the AC, internal auditor, external auditor, management and the board, Beasley et al. (2009:112) found evidence that frequent meaningful interactions among these parties was critical for effective audit

committees. Beasley et al. (2009) refer to the four components of effective audit committees promoted by DeZoort et al. (2002:42), including audit committee composition, authority, resources, and diligence and state the interviews highlight the importance of the audit committee asserting its authority (to truly oversee external and internal audit), having access to key internal and external parties (resources), and spending time to fully review information (diligence).

A few studies, including those of Turley and Zaman (2007); Beasley et al. (2000); Carcello and Neal (2003a); Carcello and Neal (2003b); and Klein (2002a), recognise the importance of standardised structures and formal requirements. However, the effectiveness of audit committees does not solely result from these formal requirements and Turley and Zaman (2007:782) state that at a time when the effectiveness of audit committees is questioned it is important to research factors such as audit committee characteristics and operations to provide answers. Turley and Zaman (2007:782) use a case study approach, interviewing nine individuals at one United Kingdom company, including the ACC, internal and external auditors, and management. According to Turley and Zaman (2007:783), in almost all instances where audit committees added value it was through informal processes and voluntary networks. Externally verified characteristics such as membership and meetings prescribed in codes only provide a partial guide to audit committee effectiveness (Turley & Zaman, 2007:783). Informal processes and the importance thereof are further discussed under praxis.

Although research on audit committee structures and composition is useful it does not consider the influence of the audit committee members or take the activities of the audit committee members into account. By merely examining agendas, minutes, number of meetings, committee independence, and committee expertise it is not possible to fully capture what is happening in practice and the influences at and outside the meetings. By only focussing on audit committee practice a risk exist of only studying appearance of governance but not the substance (Brennan & Kirwan, 2015:476). Studies on audit committees as practitioners and how practices are applied and transformed resulting in praxis are discussed in the next two sections.

#### *2.2.3.2 Audit committee as practitioners*

The literature review showed research focussing on the whole AC, individual members, or the ACC. The literature review also included research on the view of audit committee effectiveness by different stakeholders including the audit committee members themselves and external audit. The themes that emerged from the literature review indicated composition (including

independence and expertise), authority, resources, and diligences to be important for audit committee practitioners in fulfilling their roles and responsibilities effectively.

One of the earlier studies on corporate audit committee effectiveness by Spangler and Braiotta (1990:134) focussed on effectiveness in terms of the leadership styles of ACCs. Information was obtained through 77 survey questionnaires and the results suggest transformational leadership and active management by exception have a substantial impact on the performance of audit committees. Spangler and Braiotta (1990:153) also recognise audit committee members may be tempted to overrate audit committee effectiveness and senior management might be tempted to underestimate effectiveness especially if the audit committee has been critical of senior management. The possibilities of overrating and underrating were also considered during the field work visits to municipalities. Later research and the important role of the ACC were completed by Turley and Zaman (2007) and Sarens, Christopher and Zaman (2013) and are further discussed under praxis. My own experience in serving on audit committees has also indicated the importance of the leadership style of the ACC. This is further discussed in Chapter 7.

DeZoort (1997) in early research examines audit committee oversight from the internal perspective of practising audit committee members themselves. The results of the research show audit committee members recognise the need to have sufficient expertise in the oversight areas, although some respondents recognise that they do not have sufficient expertise in the areas of accounting, auditing, and the law. The results of DeZoort's (1997:222) research further indicate audit committee members fail to recognise their specified responsibilities but identified many other additional duties over and above those identified that they perform or should be performing. Audit committees have come a long way since this early research by DeZoort (1997) and there has been a huge effort by local government in South Africa to appoint audit committee members with various skills and expertise as discussed in Chapter 7.

In a study by Kalbers (1992a:26-27) the perception of external auditors on audit committee effectiveness indicate external auditors have a lower opinion of audit committees than the view of the audit committee members themselves. Cohen et al. updated their 2002 study by interviewing 30 experienced audit partners and managers, from three of the Big 4 firms, in the period after the Sarbanes-Oxley Act was implemented. They found that auditors perceive audit committees to be more diligent, active, knowledgeable, and powerful but in some cases still played a symbolic role (Cohen et al., 2010:752).

The large-sample archival studies in literature on audit committee effectiveness suggest that the quality of financial reporting is positively associated with audit committee independence (Beasley et al., 2000:453); the knowledge and experience of audit committee members in financial reporting (McMullen & Raghunandan, 1996:81); and the frequency of meetings (Abbott, Park & Parker, 2000:55). Surveys also showed the positive link between independence and knowledge with measures of effectiveness such as the support of the audit committee to the auditors in conflict situations with management (DeZoort & Salterio, 2001:31; Knapp, 1987:586) and the oversight of internal audit (Raghunandan, Read & Rama, 2001:105).

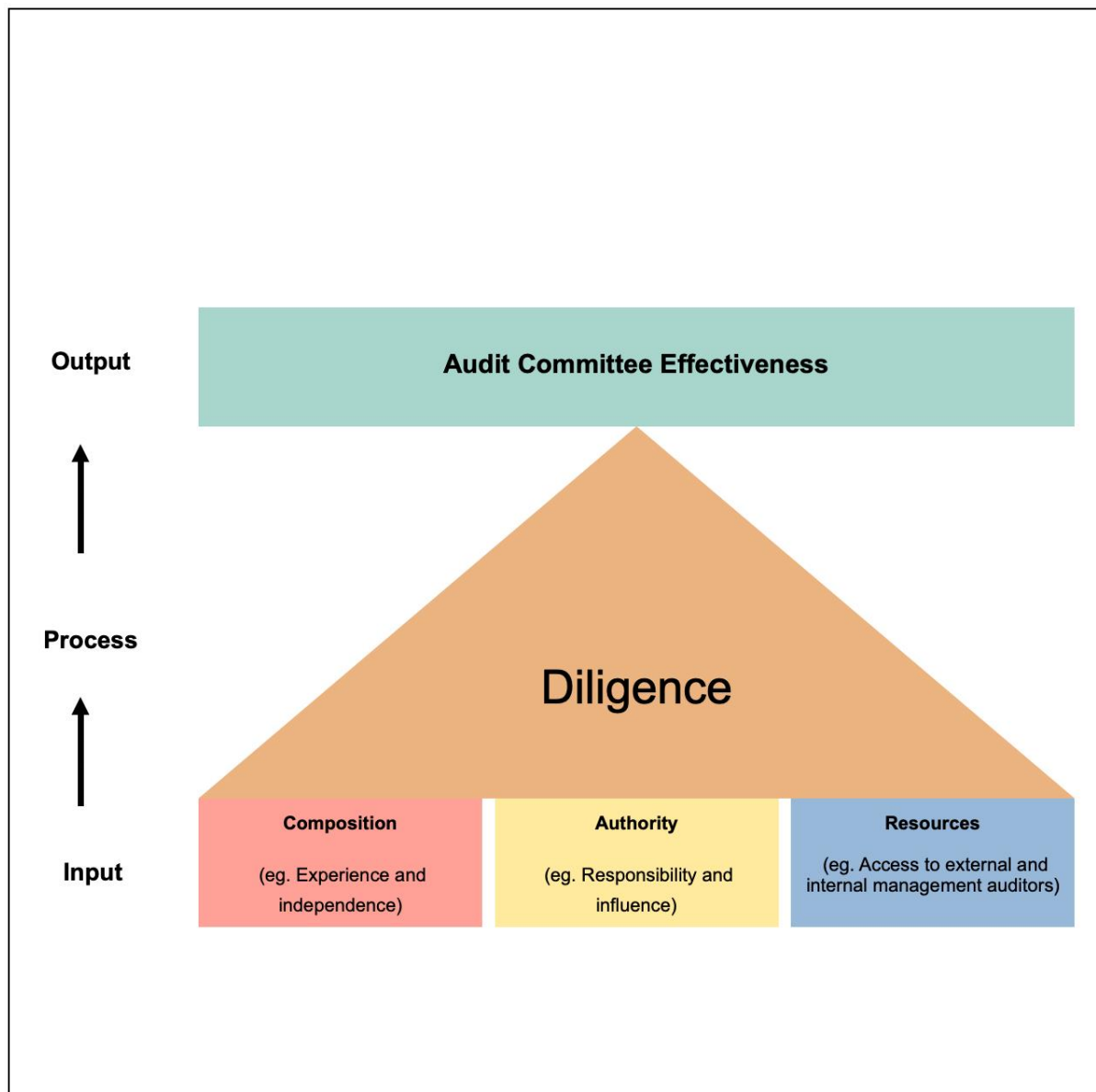
Similarly, DeZoort et al. (2002:41) described effective audit committee as having 'qualified members with the authority and resources to protect stakeholder interests by ensuring reliable financial reporting, internal controls, and risk management through its diligent oversight efforts'. Through the definition the authors extended the traditional focus on shareholder's interest to a wide variety of stakeholders and instead of focussing on individual audit committee members and their characteristics focussed on the function as a group. The key criteria of effectiveness in the definition include qualified members; authority and resources and the responsibilities of the audit committee including ensuring reliable financial information and effective internal controls and risk management. In the synthesis of empirical audit committee effectiveness literature, DeZoort et al. (2002:42-43) identified four dimensions for effective audit committees, being composition, authority, resources, and diligence, and used these four dimensions to present the results of their literature review. Figure 2.5 depicts the four dimensions identified by DeZoort et al.

Each of these inputs identified by DeZoort et al. (2002:38-75) are presented in this section with reference to other studies and own experience.

Numerous research studies on the composition of audit committees and the impact on their ability to perform their duties and activities effectively have been completed (Abbott et al., 2000:55; Abbott, Parker and Peters, 2004:69; Carcello & Neal, 2000:465; Uzun, Szewczyk, & Varma, 2004:41) and are further discussed in section 5.5. Research on composition mainly focuses on independence and expertise including financial expertise (Abbott et al., 2004; Abbott, Parker, Peters & Raghunandan, 2003; Bédard et al., 2004; Carcello & Neal, 2000, 2003a; Chen, Moroney & Houghton, 2005; Chien, 2007; Felo, Krishnamurthy & Solieri, 2003; Klein, 2002a; Krishnan, 2005; McMullen & Raghunandan, 1996; Raghunandan et al., 2001; Scarbrough, Rama & Raghunandan, 1998 and Xie, Davidson III, & DaDalt, 2003). DeZoort et



al. (2002:42) in their synthesis on audit committee effectiveness literature state composition encompass independence, expertise, integrity, and objectivity.



**Figure 2.5. Dimensions of audit committee effectiveness identified by DeZoort, Hermanson, Archambeault & Reed (2002:38-75).**

The need for independence to enhance effectiveness has been recognised throughout the research on audit committees and is one of the most common variables in the audit committee composition research literature. Studies on independence include those of Beasley, 1996; DeZoort and Salterio, 2001; Liu, 2005; Richardson and Baril, 2003, and Vicknair, Hickman and Carnes, 1993. In the synthesis of audit committee literature, DeZoort et al. (2002:48-50) identify 15 composition studies on the audit committee member independence.



Richardson and Baril (2003:36) state that 'independence, in fact', requires that the audit committee members' judgements are not tainted by their interests in management or the auditor. Independence 'in appearance' demands that a reasonable person with knowledge of the interests of the audit committee member would conclude that the member is objective'. An independent audit committee member is described by the IIA as a person who is not employed by or providing any services to the organisation other than the duties as an audit committee member (IIA, 2014:12).

A further analysis of independence studies include those studies only focussing on executive versus non-executive directors (Collier & Gregory, 1999; Menon & Williams, 1994) and studies that consider 'grey' area directors that are not executive directors but have associations with management or the companies (Carcello & Neal, 2000; Vafeas, 2001 & Vicknair et al., 1993).

The legislative requirements for audit committees within the South African local government context states in section 166 of the MFMA (56 of 2003) (RSA, 2003), audit committee members should not be in the employ of the municipality and be appointed by council. The assumption being that this would ensure independence, however, one of the risks could be that members being appointed are 'grey' in that there is some association between the members appointed and council and/or management playing an influential role in selecting members for appointment. This study would include examining the possibility of 'grey' audit committee members.

Studies on independence could also be further divided into impact of independence on external and internal audit functions, fraudulent financial reporting and governance, and company variables.

Independence studies that focus on the impact of independent audit committees on the audit function include those of: Abbott and Parker, 2000; Archambeault and DeZoort, 2001; Carcello and Neal, 2000; Carcello and Neal, 2003a; Carcello and Neal, 2003b; Raghunandan et al., 2001, and Scarbrough et al., 1998. Abbott and Parker (2000:47) found independent audit committees were more likely to use industry specialist external auditors indicating audit committees' want to ensure high audit quality. Archambeault and DeZoort (2001:33) found a negative association between audit committee independence and experience in accounting, auditing or finance and suspicious auditor switches. Carcello and Neal (2000:465) studied financially distressed companies and found the greater the percentage of affiliated directors on the audit committee the lower the likelihood of receiving a going-concern report by the auditors. Raghunandan et al. (2001:105) and Scarbrough et al. (1998:51) found that

independent audit committees have stronger relationships with internal auditors. According to DeZoort et al. (2002:51), the consistent patterns that emerge from the literature on audit committee composition indicates significant benefits associated with audit committees being independent demonstrated by the positive association between audit committee independence and audit committees engaging higher quality auditors, greater interaction with internal auditors, protecting the external auditors from client pressure, and reduced incidence of financial reporting problems.

Studies that highlight the association between audit committee independence and fraudulent financial reporting or quality of earnings include those of Abbott et al., 2000; Beasley et al., 2000; Klein 2002b; and McMullen and Raghunandan, 1996. Abbott et al. (2000:61), found that audit committees consisting of independent directors can be associated with a decreased likelihood of fraud and non-fraudulent misstatement. Beasley et al. (2000:441) found that fraudulent companies had fewer independent audit committees than no-fraud industry benchmarks. Klein (2002b:375) found that audit committee independence was negatively associated with abnormal accruals and that reductions in audit committee independence were associated with large increases in abnormal accruals. McMullen and Raghunandan (1996:80) found that companies with reporting problems were less likely to have audit committees consisting of non-executive directors.

Studies relating to audit committee independence to other governance and company variables include Beasley and Salterio (2001) and Klein (2002a). Beasley and Salterio (2001:539) found that voluntary increases in the number of outside audit committee members above the mandated minimum were associated with larger boards and board independence and the separation of the chief executive officer and board chairperson. Klein (2002a:435) found that audit committee independence was positively associated with board size and board independence and negatively associated with growth opportunities and firms that report consecutive losses.

A later study on audit committees' characteristics and the ability to prevent manager's ability to manipulate quarterly earnings as a result conducted by Yang and Krishnan (2005:215) found no significant association between audit committee independence, financial expertise, and quarterly discretionary accruals. They also found a positive association with earnings management for both independent and non-independent audit committee directors, and experience measured by tenure being associated with lower earnings management indicating learning in practice can contribute to increased monitoring of the quality of earnings. They further found strong evidence that audit committee experience on other boards as independent

directors is significantly associated with lower quarterly discretionary accruals (Yang and Krishnan, 2005:215).

DeZoort et al. (2002:52-54) analysed studies involving audit committee member expertise as part of the composition determinant of audit committee effectiveness. The researchers state the large number of studies in the areas of expertise (12 examples were referred to in the article) demonstrate the importance of audit committee expertise and related components. The audit committee experience/expertise is considered to be a critical component of audit committee effectiveness and is associated with greater interaction with internal auditors, reduced incidence of financial reporting problems and greater support for auditors in case of disagreements between management and the auditors (DeZoort et al., 2002:51). DeZoort et al. as part of their research referred to the research of, *inter alia*, Beasley and Salterio, 2001; DeZoort, 1997; Kalbers, 1992a 1992b; Lee and Stone, 1997; McMullen and Raghunandan, 1996, and Raghunandan et al., 2001. DeZoort et al. (2002:47) also found the results of studies indicate significant variation in expertise within and among audit committees and that many members lacked adequate experience and expertise in the oversight areas.

Wayne (2003:89) views the audit committee as an institution where individual audit committee members are used as a lens. His research reveals that audit committee members are of the view that the audit committee lacks many resources including business experience and skills, accounting and auditing knowledge and skills, and time (Wayne, 2003:71). Others, like Lee and Stone (1997) and DeZoort (1997), conducted the analysis on an individual level. Lee and Stone (1997:98) analysed the technical and background characteristics of audit committee members and found that they typically lacked a technical background when compared with their responsibilities. DeZoort (1997:208) analysed audit committee member's lack of task awareness and technical ability. He concluded a lack of auditing experience.

In an earlier study by DeZoort and Salterio (2001:31) research was conducted to determine whether the audit committee members' experience and knowledge affect their judgement in an auditor-management disagreement over an accounting policy. The research was motivated as a result of international concerns about audit committee effectiveness and specifically, differences in member experience, independence, and knowledge. The researchers found that the number of independent directorships audit committee members held, and the audit-reporting knowledge of the audit committee members were positively associated with support for the auditor in the case of auditor-management dispute. It was further found that concurrent board and management experience resulted in less support for the auditor. Financial-reporting

knowledge was not associated with support by the audit committee to the auditor (DeZoort & Salterio, 2001:43).

This is contradicted in later research by Beasley et al. (2009:112) where the results highlight the importance of financial expertise as part of the composition of the audit committee.

The above discussion of the literature on composition including independence and expertise provides essential information for this study. Section 1.2 identifies some of the challenges of public sector audit committees to include possible impairment of audit committee independence as a result of previous or current relationships between the audit committee and political standing and management. Another challenge identified is the difficulty in attracting a pool of suitable persons to serve on public sector audit committees. From the literature review I found that there is a strong link between independence and audit committee effectiveness and the value to the organisation. The literature also highlights the importance of not only examining the existence of a structure that symbolises independence but the necessity to research the possibility of 'grey' audit committee members through their association with council and or management. The literature review further stresses the importance of audit committee members having the necessary expertise with different opinions on what this expertise should be. Independence and expertise are further explored and presented in sections 5.4 and 5.5 of this study with the aim to provide answers to the research question of how the current composition of audit committees including expertise and independence impacts on the effectiveness of audit committees.

The second dimension related to input of audit committee effectiveness and indicated in Figure 2.5 above identified by DeZoort et al. (2002:55) is *authority*. A number of studies (eight in the literature synthesis of DeZoort et al., 2002:56-57) recognise the authority dimension of audit committee effectiveness and evaluated audit committees, specifically the oversight responsibility of audit committees, mostly through survey methods. The analysis by DeZoort et al. (2002:58) identifies several themes including that audit committee responsibilities are diverse and appear to be expanding; the key area of audit committee oversight includes the areas of financial reporting, auditing and internal controls; and the authority of the audit committee is related to written authority and management support. They also recognise that no research appears to have addressed the ultimate source of the AC's authority.

The researcher's personal experience in serving on audit committees and attending fora where audit committees in the public sector have been discussed indicated a tension between the oversight role versus the advisory role of audit committees and the impact this has on the

authority of audit committees. According to the legislative framework further discussed in section 4.3 the audit committee plays an advisory role. However, if one analyses literature on audit committees the oversight role is emphasised. For this study, the difference and application in the local government context in South Africa is further examined in section 4.6 of this thesis.

In the South African context, challenges for public sector audit committees identified also include unclear accountability, requirements, role clarity and reporting lines that impacts on authority. The roles and responsibilities of audit committees in local government in South Africa is unpacked in Chapter 4 from a legislative, audit committee charter, governance principles and application point of view to providing possible answers to the research question: 'Do audit committees have the necessary authority to ensure effective execution of their roles and responsibilities?'

The third dimension related to input of audit committee effectiveness and indicated in Figure 2.5 above identified by DeZoort et al. (2002) refers to *resources*. The analysis of 10 resource-related studies by DeZoort et al. (2002:58) indicates the resource component of audit committee effectiveness focused on support from external and internal audit and on the size of the audit committee. They concluded the audit committee literature shows support from external audit (*inter alia*, studies by Cohen and Hanno, 2000 and Knapp, 1987 and 1991) and internal audit (Raghunandan et al., 2001) is vital to audit committee effectiveness (DeZoort et al., 2002:59). In auditor-management disagreements higher quality external auditors are associated with increased audit committee support for the auditor and external auditors pay attention to audit committee effectiveness when the auditors assess risk or when they evaluate the acceptance of new clients. Studies also endorse the importance of internal audit support and interaction including the link between internal audit support and reduced incidence of financial statement fraud (DeZoort, 2002:59). The roles and responsibilities and interaction and support between the audit committees and external and internal audit are further discussed in Chapter 4. Archambeault and DeZoort (2001:33) evaluated the impact of audit committee size on suspicious auditor switching and found an association between suspicious auditor switches and smaller audit committees. DeZoort et al. (2002:59) recognise the limitation in research on resources due to the critical areas of audit committee resources including information and outside advisors not being studied. Audit committee resources are elaborated on in section 5.7.

My own experience supports the critical role internal audits play in the support of the AC. Although support and interaction between the audit committee and external audit exists it appears to be limited, which is further elaborated on in section 4.11 of this study.

The process dimension related to audit committee effectiveness and indicated in Figure 2.5 above referred to by DeZoort et al. (2002), is *diligence*, which is also further analysed in section 5.8 of this study. DeZoort et al. (2002) recognise the narrow focus of studies on diligence that only focus on the number of audit committee meetings per year while ignoring factors such as audit committee motivation and incentives or the impact of penalties for example litigation and reputational damage. Their analysis included 10 research studies and according to the researchers the literature demonstrates the importance of having an adequate number of meetings each year (DeZoort et al., 2002: 62-65). A positive association between greater meeting frequency and reduced incidence of financial reporting problems was found by Beasley et al., 2000:441 and Abbott et al., 2000:55). Archambeault and DeZoort (2001:33) further found an association between suspicious auditor switching and fewer audit committee meetings in their evaluation. Menon and Williams (1994:137) found a positive relationship between the number of audit committee meetings and the percentage of outside directors on the board. They also found that meeting frequency was associated with firm size suggesting a positive link between company size, monitoring complexity and the need for audit committee meetings. Collier and Gregory (1999:311) also placed a focus on AC's level of activity by measuring the number and duration of meetings. They found the presence of executive directors on the audit committee were negatively related to the level of activity.

Proxies other than the number of meetings for diligence included those by Kalbers and Fogarty (1993). Kalbers and Fogarty (1993) measured the perceptions of audit committee diligence through the CFO, the CAE and external audit partners. Diligence were defined as the level of preparation, vigilance, independence, and level of activity of the ACC and other members (Kalbers & Fogarty, 1993:29). A positive association between diligence and audit committee effectiveness were found and Kalbers and Fogarty (1993:24) concluded in their study that the audit committee members' will to act is arguably the most important audit committee effectiveness attribute. Beasley (1996:459) indicates that the mere presence of an audit committee may not improve monitoring effectiveness unless the committee exercise its responsibilities very attentively.

Myers (2001:68) found audit committees comprising of at least three members, one with accounting or related financial expertise and where independent members serve on fewer boards record smaller discretionary charges concluding that sufficient time, financial

knowledge, and effort are required for audit committee members to serve as effective monitors.

In a later examination of academic research on audit committee effectiveness in a large set of academic journals, Bédard and Gendron (2010:174) report a significant proportion of the studies found a positive association between effectiveness and the presence of the AC, independence of audit committees and the competencies of audit committee members. They further found the number of meetings and the size of the committee are not often positively associated with audit committee effectiveness. Their analyses of independence indicated two dimensions: the degree of independence of individual audit committee members and the proportion of independent members on the audit committee (Bédard and Gendron, 2010:187).

Gabre's (2008:2) research indicates that traditionally the effectiveness of audit committees has been measured through the criteria of independence, financial expertise, and diligence, but anecdotal evidence shows that audit committee members with these mandated characteristics of effectiveness still fail. The need for a behavioural study was identified, and her study incorporated two behavioural theories, namely escalation of commitment<sup>33</sup> and groupthink.<sup>34</sup> Within the local government terrain this would not be applicable as the audit committee according to legislation only plays an advisory role and do not have a role to play in decision-taking. Furthermore, the audit committee only meets on average four to five times per year and could not be considered to be a deeply involved group. These two theories are therefore not considered further for this study.

Purcell (2012:73) summarises the literature in relation to the role of the effective audit committee to:

"...comprise of members who understood their obligations and accountabilities and were sufficiently skilled and experienced. Members needed to meet regularly to oversee such issues as financial reporting, the risk environment, managerial oversight, and effective relationships with auditors. The knowledge and skills of audit committee members provides the attributes for the audit committee to operate effectively, while the actions of the audit committee (financial reporting, internal control and risk management), provides evidence to assess the credibility and diligence of the audit committee."

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<sup>33</sup> Escalation of commitment theory suggests when an individual is responsible for a decision and see a negative result as a personal failure the individual will show more commitment to the failing courses of action (Staw, 1981).

<sup>34</sup> Groupthink refers to the way of thinking where the members of a deeply involved group strive for unanimity rather than appraising the situation realistically (Hart, 1991).



Seawright (2015:16) in his study on audit committee quality and effectiveness refers to the resources that audit committees bring to include knowledge, skills, and competencies. Seawright (2015:16) present the results by way of three essays. Essay one reflects on the association between the number of audit committee meetings and the audit committee members' political skill. Essay two covers the audit committee members' political skill and the impact on the timely release of the audited financial reports. In the third essay, Seawright (2015:3-5) investigates if the audit committee political skills impact on audit fees. Political skill is explained as a system of social competencies including social astuteness, interpersonal influence, networking ability and apparent sincerity that enables individuals to understand others and use it to influence others for the benefit of personal or organisational objectives (Seawright, 2015:31). Although audit committee members within the local government in South Africa could possess some political skill, as defined by Seawright (2015), the audit committee has limited influence over audit fees, guidance on the number of audit committees meetings to be held are included in Circular 65, and the timelines for the release of the financial statements are legislated.

Turley and Zaman (2004) provided a broader literature overview than DeZoort et al. (2002) by examining the effects of audit committees and not their effectiveness (Spira, 2006:182). Turley and Zaman (2004:326) in their synthesis and evaluation of empirical research on the governance effects linked to audit committees found no automatic relationship between adoption of audit committee structures or characteristics and achievement of certain governance effects. The researchers analysed the effects by referring to aspects of the audit function, financial reporting quality and corporate performance (Turley & Zaman, 2004:305). They concluded the evaluation of the evidence provided a mixed picture. Some research shows beneficial governance effects linked to audit committees but in many areas the findings are inconclusive or very limited (Turley & Zaman, 2004:326). They recognised the need for research on the difference audit committees make in practice and suggest further research in the organisational and institutional contexts in which audit committees operate; theorisation of processes associated with the operation of audit committees; complementing extant research methods with field studies; and investigating unintended behavioural and expected consequences of audit committees. Turley and Zaman (2004:325) concludes as follows: "...audit committee effects need to be examined in the context in which they operate so that due account can be taken of the relational dynamics in and around the AC, and the interaction of the audit committee with other internal structures of the entity."



Spira (2006), in her article on audit committees of the 21<sup>st</sup> century, confirms the need to understand the audit committees' processes and practices and refers to the black box, the red herrings and the white powder in her discussions. She concludes as follows:

"...the 'red herring perspective' on audit committees suggests that one motivation for their establishment was a political one ... taking the spotlight away from auditors. Their widespread acceptance indicates that they do perform an important function but their operations remain opaque – black boxed – and the direct effect of audit committees in improving financial reporting quality has yet to be clearly demonstrated: the 'white powder' analogy remains compelling" (Spira, 2006:186-187).

This study on the effectiveness of audit committees in local government, the dynamic organisational context and the processes used by audit committees are considered by focussing on municipalities within two provinces using the case study methodology. Through interactions with the mayor, the CFO, the MM, CAE and ACC the study addresses some of the needs identified by Turley and Zaman (2004) and Spira (2006).

The next section presents the literature on audit committee praxis, the third category in presenting audit committee literature.

### *2.2.3.3 Audit committee praxis*

The two previous sections presented research on the practices of audit committees and the audit committee members as practitioners. Practices refer to structures, rules, and procedures. Practitioners convert practices into activities and combine and adapt practice to their needs and context, bringing theory and practice together with a view to change and improve practice. The actual activities in practice are referred to as praxis.

Praxis occurs as a result of the combination and interaction between practitioners and practice. Praxis includes the activities and what people do in practice (Whittington, 2006:619). In the context of this research it refers to activities through which governance is achieved by examining the processes and activities of audit committees within the specific context of the municipality.

The need for research studies on how audit committees operates and their processes, are identified and addressed by Spira, 1999a; Cohen et al., 2002; Gendron et al., 2004; Gendron and Bédard, 2006; Turley and Zaman, 2007; Beasley et al., 2009; Sarens, De Beelde and Everaert, 2009; Beattie, Fearnley and Hines, 2012; Salleh and Stewart., 2012; Zaman and

Sarens., 2013; Sarens et al., 2013; Beattie et al., 2014; and Cohen, Krishnamoorthy and Wright, 2017. These studies are further explored in this section.

The early research by Spira (1999a:243-244; 248), based on interviews with audit committee members and chairpersons, CFOs, and internal and external auditors suggests that corporate managers exert a great deal of influence over the audit committee activities. The influence can be ascribed to the control by management on various aspects of the audit committee meetings for example the information sent to members before the meeting. Several of the managers and auditors interviewed indicated that audit committee members' questions do not really challenge management and that the audit committee members are satisfied with vague answers provided by management.

Cohen et al. (2002:586) interviewed auditors that described the audit committee meetings to be characterised by passivity on the side of the audit committee with limited questions and interaction by audit committee members. Several respondents also indicate audit committees are ineffective and not powerful enough to resolve contentious matters with management. The research results by Gendron et al. (2004:155) contradicts the criticism raised against audit committees in the research by Spira (1999a) and Cohen et al. (2002) reflecting that the audit committee is considered to be effective by the participants.

Research into the praxis of audit committees also examined interpersonal relationships between audit committee members and governance practitioners and included the interrelationships between the formal processes and the dimensions of informal relationships, processes, and power structures of audit committees (Beasley et al., 2009:112; Gendron et al., 2004:153; Purcell et al., 2014:340; Spira, 1999a:243; Turley & Zaman, 2007).

Turley and Zaman (2007:765) researched informal processes and behavioural effects on potential audit committee effectiveness, focussing specifically on the interaction between the AC, senior management, and internal and external auditors. By following a case study approach the researchers were able to identify a number of instances where participation of the audit committee was significant in influencing governance outcomes. Turley and Zaman (2007:782) identified four significant factors that affects the contribution made by audit committees to governance outcomes that would otherwise not have been identified by way of theorisation or development of policy affecting audit committees and the contribution they make to governance outcomes. The four factors are: the importance of informal processes around the AC; the AC's influence on power relations within the organisation; relevance of historical development of governance in the organisation; and the possibility that the impact

of the audit committee may be the greatest in non-routine situations (Turley & Zaman, 2007:782). Related to the influence on power relations between stakeholders in the organisation the research found the committee play various roles including acting as an ally, arbiter, and even being used as a threat to support the authority of other organisational participants (Turley & Zaman, 2007:783).

In 2009, Beasley et al. (2009:72) studied the audit committee oversight process. They were of the view that process characteristics including selection of audit committee members (the role of the chief executive officer and the lack of accounting expertise), the audit committee meeting process (time spent on important issues, agenda setting, information flow, reliance on management and review of information), and the tendency to trust management can contribute to corporate disasters (Beasley et al., 2009:69). The researchers find that audit committee members strive to provide effective monitoring of financial reporting rather than serving on audit committees for ceremonial purposes. However, they found evidence of significant monitoring and ceremonial activities in six specific audit committee process areas. They further found that responses differed in relation to personal and company characteristics and significant variances linked to accounting expertise and time of appointment to the audit committee (Beasley et al., 2009:66). It was only through examining praxis within audit committees that these findings became apparent.

In more recent studies, researchers focus on informal interactions by the AC. Zaman and Sarens (2013:495) found that audit committees' informal interactions are significantly and positively associated with audit committee independence, audit chair's knowledge and experience, and internal audit quality. Sarens et al. (2013:307) studied informal interactions between audit committees and internal audit functions and found certain personal characteristics of CAEs, the specific knowledge and expertise of the ACC, and some of the ACC's personal characteristics are associated with the existence and increase of informal interaction. Both studies used surveys as a method of obtaining data. Zaman and Sarens (2013:511) recognise as limitations that internal audit quality cannot be easily or reliably captured using survey data, especially if it is based on CAE perceptions only, and quantitative measures can fail to adequately reflect qualitative attributes influencing audit committee interactions. By using qualitative measures, the authors are of the opinion there is a greater potential for a more substantial contextual understanding of the audit committees' informal interactions. In this study the purpose is to research the processes of audit committees, and as part of the examination, information on the informal interactions between the audit committee including the ACC and other governance role-players was obtained and discussed in Chapter 7.

The researcher's personal experience has also shown that the level of interaction between the audit committee and various role-players within the organisation is very dependent on the characteristics of the ACC and the receptiveness of the organisation including the CAE and governance role-players including the mayor and MM to meet informally with the ACC and or audit committee members.

Relating to the interactions with external audit, Beattie et al. (2012:370-371) studied the level of engagement in discussions and negotiations of the full audit committee and each triad member (ACC, CFO, and audit partner) in audit-related matters including audit planning, audit performance and audit finalisation in United Kingdom listed companies. They found there is a low priority of discussion of risk and incomplete engagement by audit committees with key audit-related issues. Beattie et al. (2012) also comment on different patterns and links between interactions based on the size of the company, the audit firm, and the audit committee composition. However, the high level of engagement between the CFO and external audit regarding audit fees and non-audit services was considered to be an area of concern, as it may be an area the audit committee should monitor more closely (Beattie et al., 2012:370-371). Beattie et al. (2012) found that audit committees play a key role in managing the relations between companies and their external auditors. The level of discussion was significantly higher in cases where audit committee members were former auditors. It was further found that where members were former auditors or members with professional accounting qualifications there was an increased likelihood that only the ACC rather than the full audit committee was involved in discussions. This may indicate that significant audit committee effects could occur outside formal structures and processes (Beattie et al., 2012:371).

In the local government in South Africa, the audit committee plays a lesser role in the relationship with external audit. Own experiences have indicated where disagreements between management and external auditors occurred the differences were usually solved between external audit and management with limited audit committee involvement. However, that situations have changed slightly over the last few years. Interactions and studies between the audit committee and other role-players including that of external audit are further addressed in Chapter 4 of this study.

In a later study, Beattie et al. (2014:318) investigated the extent to which audit committees and ACCs engage with the CFO and audit partners specifically related to financial reporting issues. Engagement referred to awareness and involvement of the audit committee and involvement of the ACC, respectively. The study found the ACCs' overall level of awareness

of discussions of financial reporting issues and of specific issues was comparable to that of the CFOs' and audit partners. The one deviation was that the ACC was significantly less likely than the audit partner to be aware of discussions around fraud and illegal acts. Another significant finding was that a substantial proportion of discussions on financial reporting issues (35.3%) did not involve the audit committee or ACC and engagement was limited between the CFO (having superior business knowledge) and the audit partner (having superior technical accounting knowledge) (Beattie et al., 2014:337). Possible explanations could be that issues are agreed or approved by the audit committee without discussions or that the audit committee plays a passive role encouraging audit partners and CFOs to resolve disputes between themselves. Another explanation offered as part of the research could be that the audit committee and ACC believe the CFOs and audit partners will act constructively and not opportunistically. Another possible reason for the high non-involvement by the audit committee put forward by the researchers was the complexity of the financial reporting issues and the audit committee possibly only having one member with relevant financial experience (Beattie et al., 2014:338).

The results of field studies of audit committee practices during meetings, including private meetings with auditors, by Gendron et al. (2004:153) highlights that key matters that are emphasised included accuracy of financial statements, appropriateness of wording used in financial reports, effectiveness of internal controls, and quality of work performed by the auditor.

Gendron and Bédard (2006:211) explore the process that informs the view on the effectiveness of audit committees by the small group of people that attend the audit committee meetings including chief executive officers, CFOs, chief internal auditors, audit partners, ACC, audit committee members and the corporate secretary. The analysis by Gendron and Bédard (2006:211) indicates the attendees' reflective acts on the substance of audit committee meetings and informal practices inform their view on the effectiveness of audit committees, with mixed views of the effectiveness by the individuals ranging from confidence, to hopefulness to anxiety about the formal duties of audit committees. The researchers found that symbols impact the view of effectiveness but that attendees also consider the audit committee processes and outcomes, and specifically the asking of challenging questions by audit committee members, to be an indication of effectiveness. The attendees' sense of effectiveness was also informed by positive outcomes, for example management and auditors being able to resolve problems together informally before the audit committee meetings and tangible indications of the outcome of work and formal authority of the AC. The attendees equate effectiveness to being where they are comfortable in the main areas of involvement of

the AC, for example the reviewing of the financial statements or the overseeing of internal control systems. The notions of effectiveness come from reflecting on audit committee processes and results, with variation among individuals on the definition of effectiveness and in the confidence that effectiveness is being achieved in a certain area (Gendron and Bédard, 2006:232).

Turley and Zaman (2007:783) found that the status of the individuals and specifically the chairperson are key elements in the impact the audit committee have on the organisation. Positive governance outcomes appear to be attained when the audit committee members are perceived to be credible for the extensive responsibilities they have. The culture of the organisation, which encourages informal interactions between different functions in the organisation and the AC, also has a perceived positive impact on governance outcomes.

Another theme of research is the role the audit committee play in resolving auditor-management dispute (Gendron & Bédard, 2006:231; Beattie et al., 2012: 371; Salleh & Stewart, 2012:1340).

The analysis by Gendron and Bédard (2006:231) found respondents' perceptions of audit committee effectiveness were informed by positive outcomes for example management and auditors being able to resolve problems together informally before the audit committee meetings. Beattie et al. (2012:354) find that audit committees do not generally expect to resolve disputes between the CFO and the audit partner but expect to be informed about problems as they develop. In a Malaysian context, Salleh and Stewart (2012:1340) found auditors and management usually engage over contentious accounting issues and where material and consensus cannot be reached the audit committee plays a mediating role and provide assistance to resolve the dispute without taking sides and the outcome is usually a compromise solution.

Another important consideration under praxis is the trust relationship between the AC, management, and internal and external audit. In earlier research by Wayne (2003:85) the element of trust also formed a major part of the research argument. Audit committee members identified the barriers to effective audit committees to include lack of technical resources; management interference with and dominance of AC; external and internal auditors not being independent; and conflict between them and the audit committee not accepting some of their mandated tasks. Conditions for effectiveness identified by the respondents included having technical resources; trust and reliance on management and external and internal auditors; control and holding the external and internal auditors accountable. Wayne (2003:85) identified

four different approaches that the audit committee can use to fulfil their role mandated by legislation.<sup>35</sup>

From the research it is clear that the audit committee needs to play a substantive oversight role, but the extent depends on the degree of trust in management and auditors. Trust or scepticism determines if the approach is a professional or agency AC. In the ideal situation where there is trust the professional audit committee need to fulfil its substantive oversight role only. However, when there is scepticism the audit committee will need to gather evidence to prove management and auditor representations. Wayne (2003) concludes that two conditions are required for audit committees to be effective. The barriers need to be removed and the audit committee need to trust managers and auditors experience (Wayne, 2003:87).

In the South African context, as indicated earlier, the external audit is conducted by the Auditor-General and the audit committee plays a limited role in overseeing the work of the Auditor-General. Together with this it is important to consider the advisory role the audit committee should play in accordance with the legislative requirements. At the same time if one considers the corporate governance guidelines contained in King IV and applicable to the local government the council must make representations on the accuracy of external and internal generated information. If the situation in South Africa is compared with the four audit committee approaches put forward by Wayne (2003), being institutional (symbolism), paralysed (lack of trust resulting in audit committee not being able to fulfil responsibilities), professional (combination of controlling and trust being a critical condition), and agency (includes substantive oversight assessing integrity of financial reporting), the need to further examine the roles and responsibilities, informal interaction, and perceptions of different stakeholders within the specific context of each municipality becomes paramount.

Sarens et al. (2009:90) studied the relationship between internal audit as supporter of and comfort provider to the audit committee and is further discussed under section 4.8.

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<sup>35</sup> The 'institutional' audit committee promotes legitimacy (symbolism) but is not the role prescribed by the regulator and as a result of failures including corporate, management and audit failures it is not considered to be an appropriate approach. The 'paralysed' audit committee is formed because the implicit trust required by the institutional approach was violated and the institutional perspective is being replaced by the scepticism of an agency/monitoring oversight world. If trust cannot be restored the 'paralysed' audit committee cannot fulfil the roles and responsibilities and no conditions of effectiveness exist (Wayne, 2003:86). Regulatory expectations and prescriptions require the 'professional' to practice oversight. The 'professional' audit committee is also a combination of controlling and monitoring requirements and the institutional element of trust. This view requires trust as a critical condition of audit committee effectiveness (Wayne, 2003:86). The 'agency' audit committee operates in a substantive and sceptical world where the practice of substantive oversight is not enough. As a result of opportunistic management and scepticism the audit committee must get evidence by independently assessing the integrity of financial reporting. This is done through auditing the auditors and management (Wayne, 2003:87).



This section on the praxis of effective audit committees includes more recent research and the themes that emerged included the importance of interpersonal relations and informal interactions between the AC, management, external audit, and internal audit. The research also focussed on the actual operations, processes and activities of audit committee members and the chairperson and the perceptions of the various stakeholders on the effectiveness of audit committees and what informs these perceptions. Most of the research was conducted through field studies and results show variances among individuals when reflecting on effectiveness of processes and results. The importance of studying within the specific context is highlighted.

The description of an effective audit committee by DeZoort et al. (2002) has been criticised as depicting the audit committee as an isolated mechanism that fails to recognise the interdependence of the components of the audit committee to the specific dynamic organisational context (Spira, 2006:181). The combination of the constitutional power (through legislation, corporate governance codes, and terms of reference), the individual power of the audit committee members (practice), and the impact the audit committee has on power relations within the organisation (praxis) produces the most significant audit committee outcomes (Turley & Zaman, 2007:783). To appreciate the extent of the effectiveness of audit committees it is necessary to look at the practice, practitioner, and praxis.

All the above discussion related to research in the corporate sector. The following section reflects on research of audit committee practices, practitioners, and praxis in the public sector and local government.

#### *2.2.3.4 Audit committee practice, practitioners, and praxis in the public sector*

A study was conducted by Irwin on characteristics of effective audit committees in the public sector (federal, state, and local governments) in the United States.<sup>36</sup> The study was informed by interviewing 135 knowledgeable individuals, analysing information of 35 audit committees, and several onsite visits. The results of the study showed that most interviewees perceived the audit committee members to be effective however the effectiveness depends directly on the capabilities of the ACC and/or audit committee members including financial literacy (Irwin, 2009:44-45).

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<sup>36</sup> In the USA there is no legal or regulatory requirements for government audit committees. However, many governments have successfully implemented audit committees (Irwin, 2009:44).



In their study on audit committee effectiveness, Magrane and Malthus (2010: 430-433) investigated informal and formal audit committee processes through a case study. They researched the effectiveness of an audit committee within the context of a New Zealand public health organisation by comparing the actual performance of the audit committee with 'best practice' guidelines, in the absence of legislative requirements for audit committees. Based on the guidelines the elements that formed part of the study included independence, financial skills and expertise, experience with organisation, relationship with stakeholders, clarity of purpose, and willingness to commit time. They also researched the effectiveness of audit committees as perceived by the stakeholders that included internal auditors, external auditors, and senior management. An interesting finding of their research was that the impact of the audit committee outside the formal quarterly meetings had the strongest impact on the organisation. In the case described by the researchers, the internal auditor and ACC met monthly for ad hoc discussions and the chair reported he received regular e-mails from the chief executive officer and CFO seeking advice. The ACC's involvement also assists in management taking action to address the internal auditor's concerns (Magrane & Malthus, 2010:438-439).

The importance of informal communications and interactions for effective audit committees in the private sector is covered in the section on praxis above. Magrane and Malthus found a strong match between the potential effectiveness of audit committees and the effectiveness as perceived by the stakeholders. Criticism raised against the audit committee by stakeholders were consistent with the deficits noted from the best practice analysis and concludes that an increase in regulation of audit committees may be beneficial to audit committees but will come at an additional cost to the organisation. Magrane and Malthus (2010: 440-441) recognise the importance of addressing the need for informal processes in the development and update of guidelines.

Limited studies on audit committees in local government were completed. Table 2.2 introduces the studies, followed by a more detailed explanation.

**Table 2.2: Summary of research on audit committees in local government**

Researchers / Authors	Title
West and Berman (2003)	Article: Audit committees and accountability in local government: A national survey
Crawford, Henry, McKendrick, and Stein (2008)	Article: Effectiveness of audit committees in local authorities: Views from key players
Fink (2008)	Thesis: Municipal accountability: Should regulations similar to the Sarbanes-Oxley Act apply to the local sector
Davies (2009)	Article: Effective working relationships between audit committees and internal audit – the cornerstone of corporate governance in local authorities, a Welsh perspective
Purcell (2012)	Thesis: Audit committee effectiveness in Victorian local government
Purcell, Francis, and Clark (2014)	Article: Audit committee effectiveness in Victorian local government

Relating to audit committees in local government in the USA, West and Berman (2003:329) completed a study relying on national survey data in cities with a population of over 65000 examining the prevalence, role and composition of audit committees and the conditions affecting their use and effectiveness. The survey data was supported by interviews and a brief case study (West & Berman, 2003:329). An interesting part of the focus of their study included to examine if the community conditions or characteristics of elected officials were linked to activities performed by the audit committee (2003:335). The results showed the organisational culture, community characteristics and relations with elected officials were associated with the performance of audit committee activities, especially ethics-related activities. West and Berman found less than 50% of the cities had audit committees. Although it was the prevailing practice to allow elected officials to serve on audit committees, less than 50% of the cities allowed elected officials to serve on the audit committees. In cases where it was allowed the finance director in 42.5% of the cities was a member of the AC. Less than a third of the cities had the functions and authority of the audit committee reflected in the city charter (West & Berman, 2003:337). On the appointment process West and Berman (2003:338) reported selection of the ACC is done by either the mayor (37.2%), the city council (25.6%), and/or the audit committee itself (25.6%). In 45.6% of the cases the selection of audit committee members was done by the city council or in 34% by the mayor. The same role-players had the authority to dismiss audit committee members or chairpersons – the city council (46.2%) or mayor (37.4%). It was also found that none of the cities remunerated their audit committee members nor had ethics standards that were solely developed for audit committee members. However, members were often subjected to the same ethical requirements as for board members.

On conditions affecting the use of audit committees, West and Berman (2003) found in contrast with the literature that independence and the need for technical knowledge were not considered to be that important by respondents in the survey. The two most important characteristics identified for audit committees by respondents were objectivity and personal integrity (West & Berman, 2003:346). Related to support to the audit committee the greatest support was found to be from city managers or chief accounting officers, followed by the elected officials or council. Weak support was provided by public managers and citizens and from local business leaders which was expected due to the low visibility and narrow but important role the audit committee plays.

West and Berman (2003:346) concluded that despite legal and professional standards and recommended best practice audit committees, the use of audit committees and the activities they performed were inconsistent. However, audit committees still augmented financial accountability in local government. The researchers found where audit committees existed although there were differences in the activities performed the audit committee created a platform that was accessible to internal and external audit and for communication with the elected officials.

Although some relevant information may be gathered from the research, the context is quite different from that of South Africa. Similarities include the oversight and advisory role of the audit committee in that the audit committee is considered to strengthen financial accountability, improve communication between the different role-players, safeguard resources, and contribute towards accountability to the community (West & Berman, 2003:331). In local government in South Africa, the appointment of an audit committee is required by legislation and not voluntary as in the USA. In South Africa it is also a requirement that the majority of the members that serve on the audit committee may not be employed by the municipality. Furthermore, it is expected practice for the appointment of the audit committee to be done by the council, however the influence of the MM and other officials in this regard are further discussed in Chapter 7. The results of West and Berman (2003) showed the organisational culture, community characteristics, and relations with elected officials were associated with the performance of audit committee activities, especially ethics-related activities, that is covered in section 4.16 of this study.

Crawford et al. (2008) and Davies (2009) conducted studies on audit committee effectiveness in both Scotland and Wales' local government, respectively. Crawford et al.'s (2008) study was from the perspectives of the ACC, CFO, and CAEs and Davies (2009) from the perspective of the CAE. Crawford et al. (2008:212-213) conclude that audit committees were effective in

monitoring internal audit but did not have the same level of engagement with the external auditors. They further found that the audit committee was not effective in the monitoring of organisational risk management and party-political issues were not influential (Crawford et al., 2008:212-213). In comparison with South Africa it is not a legislative requirement to appoint audit committees in Scotland. However, Crawford et al. (2008:208) refer to a 2004 report that recognises audit committees had been established in all Scottish local authorities. In Scotland a guidance note on *Audit committee principles in local authorities Scotland* was issued in 2004, referring to the responsibilities of audit committees relating to risk management, scrutiny of financial and non-financial performance, and following up on audit findings and recommendations (Crawford et al., 2008:207), similar to some of the responsibilities of audit committees in South Africa. A guidance circular was also issued on audit committees in local government in South Africa (refer to section 4.3) and are used in this study to, *inter alia*, measure the practice of audit committees in the sample selected.

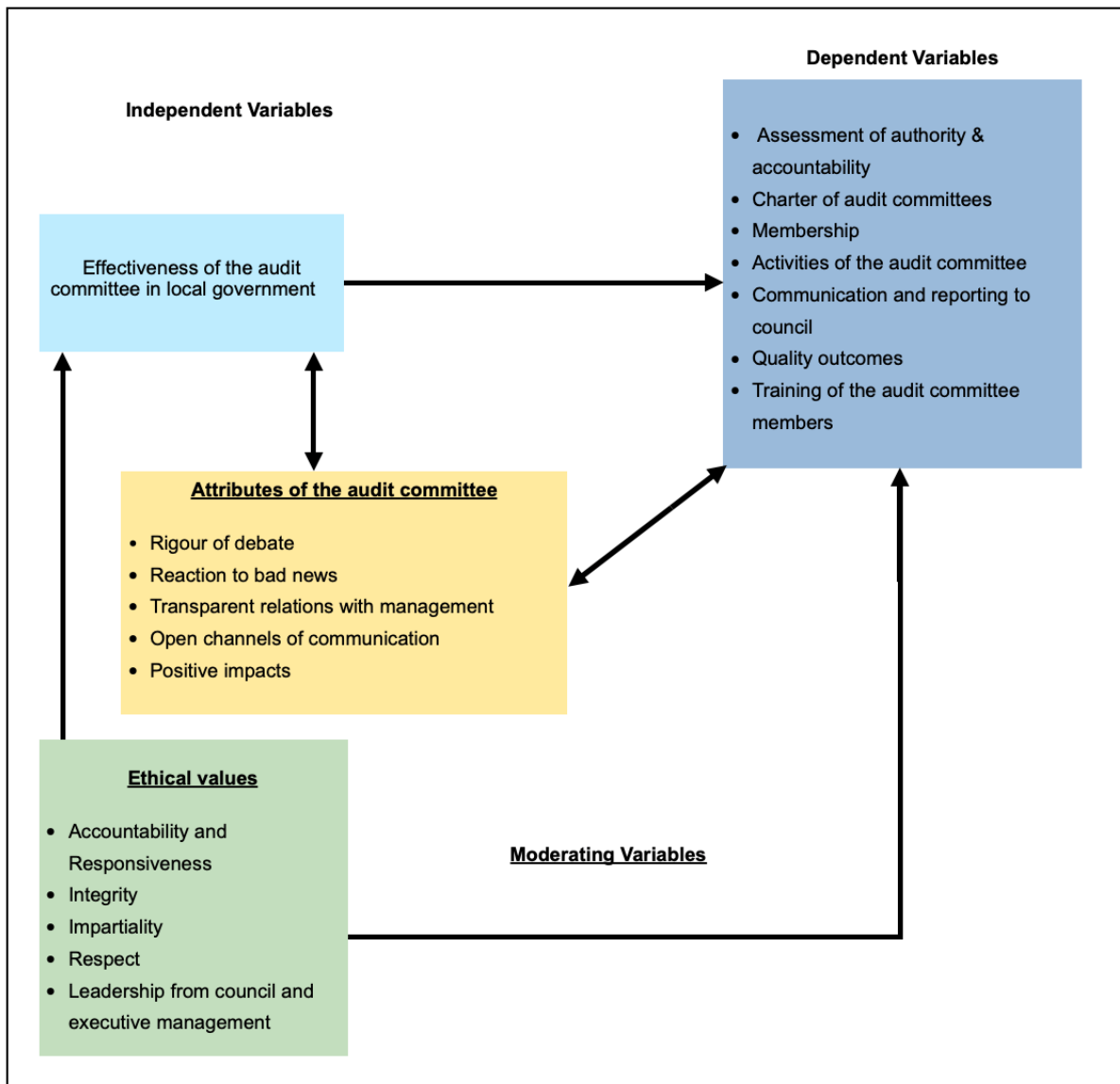
Davies (2009) concluded that the working relationship between the audit committee and internal audit will depend on individual personalities, authority, governance processes, and the willingness by all parties to adopt the published guidance on the roles and responsibilities of audit committees. Specifically related to the public sector arena of local government there is always the political issue that should also be considered. She further recognised that the differences noted among the eight respondents imply there is a long way to go before the achievement of a standardised approach to the work of the audit committee and an agreed view on their effectiveness. She also concluded the procedures for assessing performance is essential if the audit committee is to work effectively (Davies, 2009:60). The context of the study by Davies (2009) is different from the South African context in that it is not compulsory for local government in Wales to have audit committees, but it is recommended. In my view taking other research into account and the various factors impacting on effectiveness a standardised approach could work to establish practice but not practitioners and praxis due to all the different variables that impacts on perceived effectiveness of audit committees. The specific roles and responsibilities of the audit committee in the South African context including practice, practitioners, and praxis are further discussed in Chapter 4.

Fink (2008:100), in his research on the willingness of municipal finance officers to accept required adoption of Principal Officer Certification (PCO) and Independent Audit Committees (IAC), found factors such as lack of required knowledge, low or no compensation for serving compared to the private sector, the potential legal liabilities, and the amount of time required to adequately fulfil their responsibilities contribute to not being able to attract independent audit committee members for municipalities. During audit committee workshops hosted by the

Public Sector Audit Committee Forum in South Africa (attended by the researcher) and during the fieldwork, the lack of available suitable qualified audit committee members was also identified as a major challenge.

Purcell (2012) researched the effectiveness of audit committees in Victoria local government addressing the issue of possible corruption and misconduct in local government and the role of the AC. In the thesis by Purcell (2012:58), 'effectiveness' is described to mean the functional relationship between the authority and composition of the audit committees and the specific measurement of accomplishments. Purcell (2012:101) identified four themes from his literature review that are relevant and important in local government audit committee research: (1) audit committees have become a significant role-player for strengthening corporate governance in both the private and public sectors; (2) the corporate law reforms internationally have the aim of improving accountability and integrity of financial reporting and performance reporting; (3) audit committees can be viewed as a tool to enhance financial reporting, audit independence; and (4) can be the mechanism to monitor and protecting the interests of the community as the agents of the councillors. Purcell (2012:101-102), in answering the questions if audit committees are effective and adding value based on his literature review, concludes that the research suggests audit committees in local government can be effective by adding value to the oversight of the financial management process, risk management, and fraud. However, pre-conditions would include independence of audit committee members, the authority to act, resources, and due diligence. He also refers to the significant impact the capabilities of the chair has on effectiveness.

The theoretical framework used by Purcell (2012:4) and depicted in Figure 2.6 demonstrates the different variables developed using audit committee literature as a reference point.



**Figure 2.6. Theoretical basis and constructs of Purcell's research** (Purcell, 2012:4).

The dependent variables represent the formal process, activities, and outcomes of the audit committee (practices) and the moderating variables that can influence the independent variables are the attributes of the audit committee (practitioners). It is based on the *McKinsey 7S Theory* stating an effective audit committee needs formal structures, strategies, and systems (dependent variables) and the effectiveness is influenced by moderating variables including attributes of staffing, skills, and style of the audit committee within an ethical framework, meaning 'substance' rather than 'form'. The ethical values are based on the Victorian public sector values (Purcell, 2012:5-6). According to Purcell (2012:99), the *McKinsey 7S Theory* provides another interpretation to view the complexity, interdependence, and relationships between accountabilities and outcomes of the audit committee. Rather than

focusing on measures and outcomes of organisational effectiveness, audit committees focus on financial reporting and external audit relationships (Purcell, 2012:99).

The research by Purcell (2012) encompassed qualitative and quantitative data collected through a pilot survey, research questionnaires, and interviews. Qualitative and quantitative data were validated by performance indicators.<sup>37</sup> The questionnaire was used to measure the perceptions, attitudes, and perspectives of mayors, chief executives, and chairs of audit committees. The results of the questionnaire were compared with the perceptions of committee members of the representative bodies of local government in New South Wales and Victoria.

The research findings by Purcell (2012) revealed support from mayors, chief executives, and chairs of audit committees and that audit committees in Victorian local government function effectively. However, the research revealed a lack of support for the notion that investigations into local government maladministration and malfeasance enhance governance and the audit committee effectiveness (Purcell, 2012:i). The study by Purcell (2012) provided valuable information, relevant to this research.

Many contextual similarities between the environment described by Purcell (2012) and the South African local government environment exist. These include, for example, the legislative requirement to have an AC, councils appointing the audit committee members, audit committees being advisory bodies to council and not being decision-making bodies, and the audits being conducted by the Auditor-General. Some contextual differences include the composition of audit committees in Victorian local government comprising both councillors and independent members with an independent member being the chair, compared to South Africa where the requirement is that the majority of the members that serve on the audit committee may not be employed by the municipality. The public sector in Australia has also issued specific standards and policies related to public sector governance,<sup>38</sup> financial management in local government, and audit committees in local government (Purcell, 2012:62). In the Victorian context specific guidelines for audit committees in local government were promulgated in 2011 (Purcell, 2012:11) and in South Africa circular 65 was issued with limited

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<sup>37</sup> Internal performance measures include understanding by audit committees of their responsibilities, due skills and experience of audit committee members, ability to act independently and objectively, maintenance of effective relationships with council and management, timeliness of reporting by audit committee to council.

External performance measures include: quality of internal financial reporting, effectiveness of internal control, financial viability of council (all three by way of Auditor-General Reports on Local Government Results of the audits), and annual community assessment of councils (from a local government community satisfaction survey).

<sup>38</sup> Purcell lists the Australian public sector audit committee publications including from the IIA, the National Audit Office, Treasury, Contoller and Auditor-General, New Zealand, Auditor-General Manitoba, and Department of Local Government (2012:90).



authoritative power (National Treasury, 2012). Another consideration is the difference in focus between the study by Purcell and the researcher in this study. Purcell (2012) focussed on risk management and corruption and misconduct in local government while this research focuses on the whole spectrum of roles and responsibilities of the audit committee in local government. Another difference is the extent of guidance documents to audit committees in local government in Australia versus South Africa. Similar to South Africa, councillors are legislatively required to appoint audit committees and audit committees are also expected to assist councillors and executive management in the 'mutual obligations towards honest stewardship' in the Victorian local government (Purcell et al., 2014:339).

What differentiates this study from the one of Purcell (2012) - other than being in another country - is that this study also includes the perceptions of the CAE. Furthermore, this study uses qualitative methods only and does not provide a comparison with the views on audit committee effectiveness by the representative bodies of local government.

Within the South African context, three relevant studies were identified as part of the literature study. Marx (2008) completed an analysis of the development, status, and functioning of audit committees at large listed companies in South Africa and Van der Nest (2006) investigated audit committees in the South African public service to determine how effective public service audit committees are in assisting accounting officers of government departments in discharging their responsibilities. Miso (2011) completed a qualitative study, using the case study of Stellenbosch municipality, in Western Cape, South Africa, researching the role of council committees in promoting financial accountability. The two main committees that formed part of the research were the audit committee and the oversight committee (also referred to as the Municipal Public Accounts Committee).

Although the research by Marx (2008:23) does not focus on the public sector, he recognises his findings of the study can also add value to audit committees in the public sector. Marx (2008) recognised that although audit committees were well established in South Africa, they were not always effective as evidenced by the corporate collapses, fraudulent financial reporting and other irregularities occurring while the audit committees existed. He identified various contributing factors including a lack of understanding the role of audit committees and support to them, lack of understanding by audit committees themselves, lack of authority and resources, lack of independence, experience, skills, financial literacy, and expertise (Marx, 2008:345).



Van der Nest (2006:219) investigated the composition and characteristics of audit committees in national departments of the South African public service, compliance with best practice and the perceived effectiveness of the audit committees. The perceived effectiveness was measured in the areas of corporate governance/oversight (62% perceived effectiveness), risk management (63% perceived effectiveness), financial reporting (69% perceived effectiveness), support for external audit (65% perceived effectiveness), and internal control (76% perceived effectiveness) (Van der Nest, 2006:v). A low percentage of audit committees (58%) evaluated compliance with internal audit standards and not all the audit committees met with the Auditor-general without management being present. His overall conclusion was that the majority of national department audit committees complied with legal requirements and best practice recommendations including meeting procedures, agenda items, and legislation, but communication with management and the accounting officer was found to be inadequate. The results of the correlation between compliance with best practice and perceived effectiveness indicated that mere compliance with legislation and best practice requirements were not directly associated with the perceived effectiveness of audit committees (Van der Nest, 2006:223).

The perceptions of the CAEs, ACCs, the Office of the Auditor-General, CFOs, and some accounting officers were measured using semi-structured interviews. He noted major differences in the perception of quality and effectiveness of audit committees among departments and between members themselves and the internal and external auditors (Van der Nest, 2006:187). Challenges identified by participants included lack of commitment and a proper preparation for meetings by audit committee members, reluctance to take specific and managerially complex decisions and hold management accountable for actions or the lack of implementation of control mechanisms (Van der Nest, 2006:214).

Van der Nest (2006:225-226) recommended that executive management should attend all audit committee meetings and for regular communication and interaction between the accounting officer (chief executive officer) and the ACC. The recruitment process should result in the appointment of knowledgeable and experienced audit committee members.

Although the studies of Marx (2008) and van Der Nest (2006) are not recent, they provide valuable information for this study in providing information for the South African context.

Carcello et al. (2011), based on their literature review and synthesis on governance-related literature focussing on corporate board and audit committee issues, suggest future research to include interactions and relations among the various governance practitioners. Another

future governance research area could include the effects of governance characteristics given different entity conditions. Furthermore, research could be extended from US firms and countries that follow the Anglo-American traditions of governance to firms in continental Europe and developing countries (Carcello et al., 2011:22). The researchers state that the most promising area of future governance research is to further explore what actions, behaviours, processes, and personality traits contribute to board and audit committee effectiveness (Carcello et al., 2011:24). They recognise that field studies will need to be conducted for these studies following a holistic approach with interviews with directors (council and MM in this research), external audit, and internal audit. They suggest researchers can examine the determinants of audit committee effectiveness, including meeting preparation, meeting performance and actions between meetings, how the actions of the audit committee can enhance effectiveness of the financial reporting function, and internal and external audit processes. Further suggested research can also include how the audit committee can oversee top management since most of the accounting frauds involve chief executive officers and/or CFOs. It is the last point that creates a challenge in the local government environment based on the legislative mandate that is further explored in Chapter 4. In terms of other governance mechanisms, the researchers also indicate the need for research on the relation between risk management, compliance, and ethics functions, usually reporting to the audit committee and how the audit committee can best interact and oversee the functions (Carcello et al., 2011:26). This confirms the need for this research in South Africa using the methods proposed.

#### **2.2.4 Conclusion**

For this study it is considered important to use practitioners, practices, and praxis forming an integrated framework to study the effectiveness of audit committees in local government. What emerges from the analysis of studies on audit committee effectiveness in this chapter are the following considerations, which are influential in the local government audit committee research: (1) the practice, practitioners' role, and praxis need to be considered in the perceived effectiveness of audit committees in local government; (2) under practice it is important to consider the requirements of legislation and governance guidelines and compliance thereto; (3) under practitioners it is important to include all relevant stakeholders, including management, that form an important part of the governance framework; (4) it is also necessary to examine the composition, authority, and resources available to the AC; (5) there is a requirement to determine whether the audit committee plays a substantive role versus a mere ceremonial role; (6) praxis requires the need to study what happens in practice including the formal and informal relationship and interactions between the audit committee and other

governance practitioners; and (7) the support provided to the audit committee needs to be reviewed.

The research on audit committee effectiveness outlined in this chapter suggests that audit committees in the private and public sector can be effective by adding value to the oversight process if they are independent, have the authority to act, are provided with resources, and demonstrate due diligence. The role of the ACC, the composition of the audit committee and the interactions between the governance practitioners can influence the effectiveness of the audit committee.

In the next chapter, audit committees as an integral part of the governance process in local government is discussed, followed by an analysis of the roles and responsibilities of the audit committee in South African local government in Chapter 4. The determinants of effective audit committees in local government are further assessed in Chapter 5. Chapter 2, together with Chapters 4 and 5, form the basis for the methods used (Chapter 6) and the research findings in Chapter 7.

## CHAPTER THREE: AUDIT COMMITTEES AS PART OF GOVERNANCE IN THE PUBLIC SECTOR

### 3.1 Introduction

Audit committees form an integral part of governance practices. Chapter 3 begins by discussing the meaning, principles, and value of [corporate] governance in the public sector. It is followed by analysing the different role-players forming part of [corporate] governance in local government. To provide context for this study the next section describes the municipal structure. After describing the municipal structure, the content is then narrowed down to the specific part audit committees play in the *eseke/le* of [corporate] governance in the public sector and local government including the developments that influenced this. This chapter concludes with the contributions audit committees make to corporate governance. Section 3.1 introduces corporate governance and the principles and values thereof in the public sector.

### 3.2 Meaning, principles, and value of corporate governance in the public sector

Corporate governance issues have been discussed and researched over many years as reflected on as part of the literature review in Chapter 2. Marx<sup>39</sup> (2008) in his research noted the first audit committee was formed as far back as 1872. During 1960 and the early 1970s the role of the external auditor was questioned due to the many fraud cases in the USA and Canada as a result of fraudulent financial reporting. This resulted in the development of audit committees with their main responsibility being the appointment and remuneration of the external auditor (Marx, 2008:60). During the 1990s corporate governance again came to the forefront with corporate collapses due to management fraud, fraudulent financial reporting, and auditor ineffectiveness. This is evident by the release of the Cadbury Report in 1992<sup>40</sup> that focussed on corporate governance where after many countries issued corporate governance codes.<sup>41</sup> The development of different codes also reflect a change from merely

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<sup>39</sup> For historical development of audit committees refer to Marx (2008:97-114).

<sup>40</sup> The first formally recognised code, *Report of the Committee on the Financial Aspects of Corporate Governance* (Cadbury Report).

<sup>41</sup> The European Corporate Governance Institute on their website provides a list and links of all the codes per country ([http://www.ecgi.org/codes/all\\_codes.php](http://www.ecgi.org/codes/all_codes.php)).

protecting the interests of shareholders to the interest of other stakeholders and society at large (Marx, 2008:66). The following statement in the King II report:

Unlike its counterparts in other countries at the time, the King Report 1994 went beyond the financial and regulatory aspects of corporate governance in advocating an integrated approach to good governance in the interests of a wide range of stakeholders having regard to the fundamental principles of good financial, social, ethical and environmental practice. In adopting a participative corporate governance system of enterprise with integrity, the King Committee in 1994 successfully formalised the need for companies to recognise that they no longer act independently from the societies and the environment in which they operate (IODSA, 2002:7).

Corporate governance centres essentially on accountability (Keasey & Wright, 1993:291; Marx, 2008:69). Van der Nest (2006:139) recognises that good corporate governance requires a relationship of accountability among the various role players, and that such a relationship enhances corporate performance. The King Code of Governance for South Africa, identifies effective leadership as a key aspect of good governance, with leadership characteristics being the ethical values of responsibility, **accountability**, fairness, and transparency; all based on moral duties (IODSA, 2009:9).

The concept of accountability has been the subject of extensive academic research. In the King IV report accountability is defined as follows: 'The obligation to answer for the execution of responsibilities. Accountability cannot be delegated, whereas responsibility can be delegated without abdicating accountability for that delegated responsibility (IODSA, 2016:9). According to Purcell (2012:3) local government is fully accountable for community resources in terms of propriety, probity, legality, financial diligence, efficiency, and effectiveness. Van der Nest (2006:35) also refers to financial accountability in the public sector and Behn, recognises accountability cannot be restricted to financial accountability only. Accountability should be extended to include accountability for fairness and accountability for performance. Accountability for fairness implies that government will be fair to the various stakeholders involved in programmes delivered and in its provision of services to the public; and accountability for performance refers to government achieving its mandate and objectives (Kobrak, 2002:417). From the different definitions Ebrahim (2010:102) concluded that accountability is about relationships between different actors; where some have to account for their actions and decisions and others receive and judge those accounts.

The link between governance, accountability, a successful democracy, and the role the audit committee plays in these is described by Hepworth and De Koning (2012:7) as follows:

“There is a close link between good governance and a successful democracy. Effective GACs [government advisory committees] contribute to the development of democracy. Democracy is about informed political choice – but informed choice depends on the availability of reliable and impartial information. It also depends upon effective accountability. Reliability, impartiality, and accountability together equal transparency and are central to good governance. The role of an audit committee is to ensure that the published financial and related performance information is reliable and impartial and that it presents a true picture of the operations of the organisation. This means that the financial and related performance information available to management needs to be reliable and impartial as well.”

Purcell (2012:16) describes corporate governance as ‘a set of principles adopted by an organisation to provide assurance that there is a clear direction, responsibility and accountability for those directors and executives managing the organisation’.

In a study by Cohen et al. (2010) on corporate governance and the audit process they requested participants to define governance. The auditors identified internal control and the corporate culture in their definition of governance in line with academic literature and practice where the monitoring role of the board, the overall control environment and the corporate culture are considered to be fundamental to achieving governance (Cohen et al., 2010:762).

The meaning of corporate governance in the international and Southern African context have evolved over time. In the King I report corporate governance was explained as ‘simply the system by which companies are directed and controlled’ (IODSA, 1994:1). The King II refers to the definition of Sir Adrian Cadbury that ‘Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals ... the aim is to align as nearly as possible the interests of individuals, corporations and society’ (IODSA, 2002:7). The King III report equates good corporate governance to effective leadership that is characterised by the ethical values of responsibility, accountability, fairness, and transparency (IODSA, 2009:10).

King IV defines corporate governance as:

the exercise of ethical and effective leadership by the governing body towards the achievement of the following governance outcomes:

- Ethical culture
- Good performance
- Effective control
- Legitimacy (IODSA, 2016:11).

King IV also states within the context of sector supplements ‘corporate’ refers to organisations that are legal entities separate from their founders and include companies, voluntary associations, retirement funds, trusts legislated entities and others. ‘Corporate governance’ is used to differentiate it from other forms of governance for example national or political governance and although this study focus on the public sector the term ‘corporate governance’ is used (IODSA, 2016:75).

Within the period of issuing different corporate governance codes, a protocol on corporate governance specifically for the public sector, and applicable to public entities (state owned entities) was issued. The protocol on governance was issued to amplify and not supersede the principles contained in the King Code. The protocol describes corporate governance as ‘embodies processes and systems by which corporate governance enterprises are directed, controlled and held to account’ (Department of Public Enterprises, 2002:3).

Purcell et al. (2014:339) describes public sector governance to relate ‘to a set of principles to provide assurance that there is a clear direction and accountability for those directors and executives managing the organisation’.

The International Federation of Accountants (IFAC) and The Chartered Institute of Public Finance and Accountancy (CIPFA) jointly developed an International Framework on Good Governance in the Public Sector and defined governance in the public sector as follows:

“Governance comprises the arrangements put in place to ensure that the intended outcomes for stakeholders are defined and achieved” (IFAC & CIPFA, 2014:8).

The framework document included in Appendix B provides a further 12 existing definitions of governance by different organisations focussing on the public sector (IFAC & CIPFA, 2014:34). Within the various codes and corporate governance guidance documents, principles of corporate governance have also been set out.

Included in the Framework issued by IFAC and CIPFA the principles of governance in the public sector are depicted in Figure 3.1. It shows two of the seven principles including ‘managing risks and performance through robust internal control and strong public financial management’ and ‘implementing good practice in transparency, reporting, and audit, to deliver effective accountability’ (IFAC & CIPFA, 2014:11) form part of good governance and are specific areas the audit committee has oversight responsibility for, as indicated in chapter 4.





**Figure 3.1. Relationships between the principles for good governance in the public sector (IFAC & CIPFA, 2014:11).**

Within the South African context, the King II identified the seven characteristics of good corporate governance to include discipline, transparency, independence, accountability, responsibility, fairness, and social responsibility (IODSA, 2002:11-12). The King III expands on these principles and includes seventy five principles in total in the chapters of ethical leadership and corporate citizenship; boards and directors; AC; governance of risk; governance of information technology; compliance with laws, rules, codes and standards; internal audit; governing stakeholders relationships and integrated reporting and disclosure (IODSA, 2009:19-111). The similarities between the IFAC and CIPFA framework and the King III principles include ethical leadership, governance of risk and stakeholder relationships and integrated reporting and disclosure. The King III however devotes complete chapters to the AC, governance of information technology and compliance that is particularly important for this study.



The King IV scaled down on the number of principles and identified seventeen principles towards corporate governance (refer to Table 3.1). The practice, practitioners and praxis of the AC, the topic of this thesis, have links to principles two, five, seven, eight, nine, ten, eleven, twelve, thirteen and fifteen.

**Table 3.1: Principles towards good governance**

Principle number	Description	Link with audit committee responsibilities
1	Governing Body should lead ethically and effectively	
2	Governing Body should govern ethics in a way that supports establishment of an ethical culture	Audit committee reviews ethical processes and report to Council on their findings.
3	Governing Body should ensure actual and perceived view of the organisation is that of a responsible corporate citizen	
4	Governing Body should appreciate the inseparable elements of the value creation processes to include core purpose, risks and opportunities, strategy, business model, performance, and sustainable development	
5	Governing Body should ensure reports issued by the organisation enable stakeholders to make informed assessment off the performance and short, medium, and long-term prospects	Part of the responsibilities of the audit committee is to review the annual financial statements, annual report and performance reports and recommend to Council the adoption of the information
6	Governing Body should serve as focal point and custodian of governance	
7	Governing body should comprise the appropriate balance of knowledge, skills, experience, diversity, and independence to be able to discharge the governance roles and responsibilities objectively and effectively	The audit committee needs to be independent according to legislation and best practices and comprise of members with the necessary knowledge, skills, and experience
8	Governing body should ensure the arrangements for delegation within its own structures promote independent judgement and assist with balance of power and the effective discharge of its duties.	Certain functions are delegated to the audit committee in accordance with the Audit Committee Charter.
9	Governing body should ensure the evaluation of its own performance and of its committees, the chair and individual members contribute towards improvement in performance and effectiveness	Performance evaluations of the audit committee need to take place.
10	Governing body should ensure that the appointment of and delegation to management contribute to clear roles and effective exercise of authority and responsibilities.	Certain functions are delegated to the audit committee in accordance with the Audit Committee Charter and should contribute to clear roles, authority, and effective exercise of responsibilities.
11	Governing body should govern risk so that it supports the organisation in setting and achieving strategic objectives.	Audit committee needs to oversee risk management process.
12	Governing body should govern technology and information that supports the organisation to set and achieve strategic objectives.	Audit committee should oversee governance of information technology.
13	Governing body should govern compliance with applicable laws, rules, codes, and standards to support the organisation in being ethical and a good corporate citizen.	Audit committee should oversee compliance management.
14	Governing body should ensure fair, responsible, and transparent remuneration to support achievement of objectives.	
15	Governing body should ensure the assurance services and functions enable an effective control environment, and that it supports the integrity of information for internal decision-making and the external reports of the organisation.	Audit committee should oversee assurance services and combined assurance.
16	Governing body should adopt a stakeholder-inclusive approach that balances the needs, interests, and expectations of material stakeholders in the best interests of the organisation.	
17	Governing body should ensure responsible investment	

Source: IODSA, (2016: 41-42)

The literature review included in Chapter 2 demonstrated the value of corporate governance. Mervyn King, the Chairperson of the King Report on Governance, South Africa, describes the importance of governance in the public sector as follows:

While a great deal of work has been done on this subject [corporate governance] in the private sector, there has been less in the public sector. And some of that has become dated as expectations changed and greater recognition emerged of the significant role that poor governance (and especially weak public financial management) in the public sector played in the sovereign debt crisis. ... Good governance in the public sector is essential if governments around the world are to play their proper role in the long-term development of our economies and societies, and in the protection of our natural environment (IFAC & CIPFA, 2014:5).

Section 3.3 explores the different role-players in the governance *eseke/we*.

### **3.3 Different corporate governance role-players in local government**

Research on audit committees recognise the importance of relationships between the AC, executive management and the auditors and the extent to which it improves the quality of financial reporting and other governance processes within the organisation (Gramling, Maletta, Schneider & Church 2004:240; Spira & Page 2003:641; Turley & Zaman 2004:325; Zain & Subramaniam 2007:906 and Zaman & Sarens 2013:498).

Although this research focus specifically on the audit committee it would not do justice if the other role-players and their role in the governance area is not further investigated and reflected on. DeZoort et al. (2002:67) emphasised the need for further research on the relationships and interfaces among audit committees and external auditors, internal auditors, management, and legal counsel due to the required dependencies among the groups. Brennan and Kirwan (2015) identified limited available research on the interaction and communication between governing bodies, management, and the audit committees. They recognise pre-requisites to understand the function of the audit committee is to investigate the extent to which governing bodies empower/disempower audit committees and the network that audit committees use to fulfil their roles and responsibilities (Brennan & Kirwan, 2015:477). National Treasury in circular 65 on internal audit and audit committees state the importance of engagement between the mayor, MM and the audit committee and internal audit (National Treasury, 2012:1).

To be able to identify the different role-players in the municipal context relevant for this research the Supplement for Municipalities in the King IV Report on corporate governance provide the necessary guidelines. According to principle 6 of the King IV supplement for Municipalities, the council serve as the focal point and custodian of corporate governance in the municipality (IODSA, 2016:82). The Constitution in section 151 assigns both legislative and executive authority to the council (RSA, 1996). The Public Sector Audit Committee Forum also identified the relevant governing body to include the council of the municipality in the guidance paper on the Relationship between the Public Sector Audit Committee and Management (IODSA, 2014d). The legislature is the highest authority, however the legislature cannot perform all the required functions and needs committees, the executive and administration to support it, but at the same still needs to exercise control to ensure powers are only used for the well-being of the community. It is within this context that the role of the audit committee is important, and the specific legislative requirements are discussed in Chapter 4.

Table 3.2 equates the terminology used in general for corporate governance role-players to the terminology applicable in local government.

**Table 3.2: Corporate Governance terminology in the municipal context**

Term used in the King IV Code	Relevant term for municipalities
Organisation	Municipality
Governing body	Municipal Council
Management	Management of the municipality, including the MM as accounting officer and senior management
Members of the governing body	Councillors
Chair of the governing body	Speaker
Chief Executive officer	MM or accounting officer
External auditor	Auditor-General of South Africa
Shareholder	Municipalities do not have shareholders, but in many respects, community members can be regarded as such. <sup>42</sup>

(IODSA, 2016:80)

The office of the mayor or executive mayor of a municipality does not have an equivalent in the King IV but it is suggested that for the politically elected positions the relevant legislation including the Local Government Municipal Structures Act (117 of 1998) (RSA, 1998), the MFMA (56 of 2003) (RSA, 2003), and other relevant legislation must be followed.

<sup>42</sup> Shareholders or community members in the government environment cannot control the governing body or the audit committee directly but can influence them. In recent times, community activism has become an effective tool to demand changes.

AGSA (2015:13) also identified the different role-players that need to play a role in the improvement of key controls to include MMs, mayors, senior management, internal audit units and audit committees, municipal councils, municipal public accounts committees, national and provincial government and provincial legislature. The different governance roles of these role-players are elaborated on below.

According to the AGSA (2018:87) the role of the MM is critical to ensure timely and credible information and accountability, transparency, and service delivery. According to the MFMA (56 of 2003) (RSA, 2003) the role of the MM include to ensure strong financial and performance management systems including full and proper records, effective financial and risk management and internal controls and internal audit. The MM also fulfils oversight and is accountable to ensure the efficient, effective, and economic use of resources and to prevent unauthorised, irregular, and fruitless and wasteful expenditure. The MM should act with honesty and integrity in the best interest of the municipality, manage and safeguard assets and take appropriate disciplinary steps against officials that commits an act of misconduct. The MM should also disclose all material facts to the council or mayor (AGSA, 2018:87). The MM is responsible to ensure council policies are implemented and is accountable to the mayor and council for the overall administration of the municipality according to the guidance paper issued by the Public Sector Audit Committee Forum on the relationship between the public sector audit committee and management (IODSA, 2014).

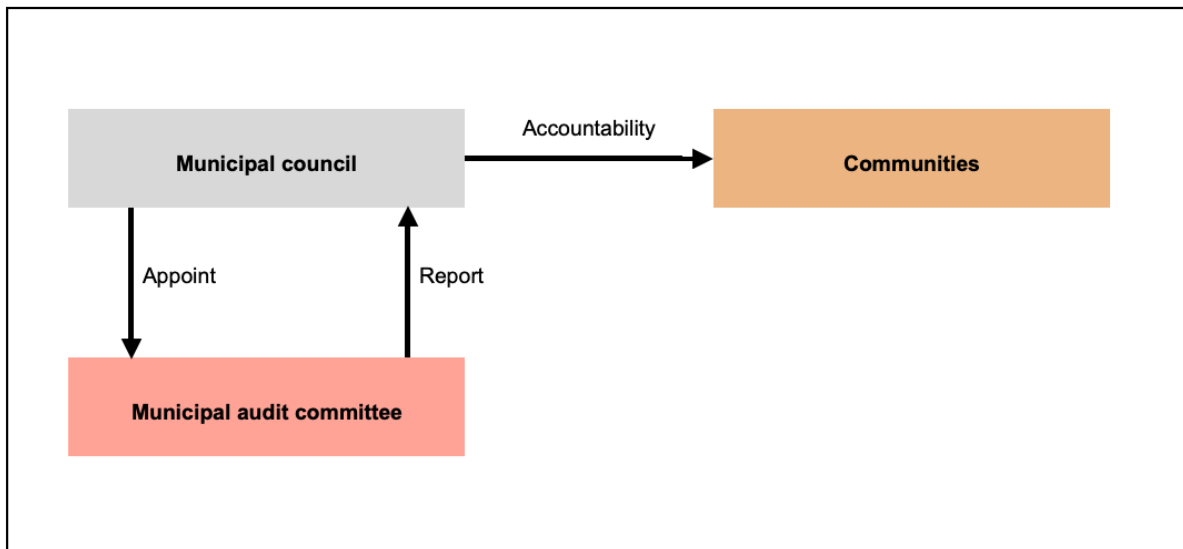
Mayors have monitoring and oversight responsibilities in terms of the MFMA and the Municipal Systems Act and includes reviewing the integrated development plan (strategic plan), budget management and ensuring the issues raised in audit reports are addressed (AGSA, 2018:87). The audit committee plays a key role in following up on the implementation of corrective actions on audit findings and should report to the council in this regard. The mayor should also manage the performance of MMs.

The guidance documents issued by the Public Sector Audit Committee Forum addresses the relationship between the public sector audit committee and management. Management includes the MM and all other municipal employees that report directly to the MM, heads of departments and executive managers. The guidance paper suggests twelve practical tips to aid the relationship between the audit committee and management including, *inter alia*, the need for a cooperative approach to encourage continuous improvement. Furthermore, for management to provide complete and relevant information to the AC, implement an effective internal control environment and support the audit committee (IODSA, 2014d).

The establishment of an IAF is a legislative requirement (MFMA section 165(1)). The IAF assist the MM to comply with the legislative and governance requirements by providing independent assurance on internal controls, financial information, risk management, performance management and compliance with legislation.

External audit, the Auditor-General South Africa, also play a particularly important role as a corporate governance role-payer. In 2018 through the Public Audit Amendment Act No. 5 of 2018; the mandate of the Auditor-General was expanded (RSA, 2018). The amendments enable the Auditor-General to focus on and assess the existence of material irregularities in transactions and balances so that activities impacting on financial sustainability can be identified and pursued. According to the expanded mandate the Auditor-General can refer a suspected material irregularity to a public body with a mandate and powers to investigate and take appropriate action where necessary. The Auditor-General can also make recommendations in the audit report on how a material irregularity should be addressed, within a stipulated period. If such recommendations have not been implemented by the stipulated date, the Auditor-General must take binding remedial action; and if the material irregularity involves a financial loss, the Auditor-General can issue a directive to the accounting officer or accounting authority to quantify and recover the loss from the responsible person. Failing to implement the remedial action the Auditor-General must issue a certificate of debt in the name of the relevant person to recover the loss (AGSA, 2019).

Governance roles and responsibilities of audit committees are discussed in detail in Chapter 4. The establishment of the audit committee is a legislative requirement, an independent body that advises the MM, senior management and the council on matters including internal controls, risk management, performance management and compliance with legislation. The audit committee is also required to review the adequacy, reliability, and accuracy of financial and performance information. Municipal councils, being the executive and legislative authority plays a monitoring and oversight role. To enable councillors to fulfil this role the MM and senior managers must provide the council with regular reports on financial performance and service delivery performance. The MFMA (56 of 2003) (RSA, 2003) and the Municipal Systems Act (32 of 2000) (RSA, 2000) also require council to investigate and act on poor performance such as financial misconduct and unauthorised, irregular as well as fruitless and wasteful expenditure (AGSA, 2018:88). Figure 3.2 demonstrates the relationship between the council and audit committees.



**Figure 3.2. Relationship between council and the audit committee (IODSA, 2014e)**

Coordinating and monitoring departments including national and provincial government departments and provincial legislature should assist municipalities in building capacity to support efficient, effective, and transparent financial management. In terms of the Constitution (RSA, 1996) the National Assembly and provincial legislatures must maintain oversight of the executive authority that is responsible for cooperative governance. Executive authority includes the minister and members of the executive council. The portfolio committee on local government is used to conduct such oversight (AGSA, 2018:88).

The municipal public accounts committee is a committee of council with the role to improve governance, transparency, and accountability. The municipal public accounts committee deals specifically with the annual report of the municipality, financial statements, and audit outcomes (AGSA, 2018:88).

Before the roles of audit committees in municipalities are discussed in section 3.4, the next section provides a brief overview of the municipal structures in South Africa.

### 3.4 Municipal structures in South Africa

Effective governance in local government relies on councillors and staff acting in the public interest and making responsible decisions on those matters that affect the lives and livelihoods of individuals, organisations, and businesses. This section introduces the municipal structure to provide context for this research.

The Constitution of the Republic of South Africa devotes Chapter 7 to local government. Section 151 provides a municipality with the right to govern, on its own initiative, the local government affairs of its community, subject to national and provincial legislation provided for in the Constitution (RSA, 1996). The Constitution further stipulates the objectives of local government to include:

- providing democratic and accountable government for local communities;
- ensuring the sustainable provision of services to communities;
- promoting social and economic development;
- promoting a safe and healthy environment; and
- encouraging the involvement of communities and community organisations in the matters of local government (RSA, 1996: Section 152).

The Constitution provides for three different categories of municipalities including: Category A municipality that has exclusive municipal executive and legislative authority in its area; Category B municipality that shares municipal executive and legislative authority in its area with a category C municipality within whose area it falls and Category C municipality that has municipal executive and legislative authority in an area that includes more than one municipality (RSA, 1996: Section 155).

Subsequent to the Constitution three key pieces of legislation affecting local government were issued: The Local Government Municipal Structures Act, No. 117 of 1998 (RSA, 1998); the Municipal Systems Act, No.32 of 2000 (RSA, 2001a) and the MFMA (56 of 2003) (RSA, 2003). The Municipal Structures Act (RSA, 1998) provide for the establishment of municipalities per categories and types of municipality according to criteria to provide for an appropriate division of functions and powers; to regulate the internal systems, structures and office-bearers of municipalities and provide for appropriate electoral systems.

The Municipal Systems Act (RSA, 2001a) define the legal nature of the municipality, core principles, mechanisms, and processes to enable municipalities to contribute to the social and economic upliftment of local communities and ensure access to essential services that are affordable to all. The Act promotes partnership between the political and administrative structures within the municipality by prescribing municipal powers and functions and provide for community participation. The Act provides an enabling framework for the core processes of planning, performance management, resource mobilisation, local public administration, and human resource development; the provision of services, credit control and debt collection (RSA, 2001a). The Municipal Systems Act (RSA, 2001a) in section 2 describes a municipality



as an organ of state within the local sphere of government that exercise legislative and executive authority within a demarcated area. The MFMA aims to secure sound and sustainable financial management at municipalities and establish treasury norms and standards for the local sphere of government (RSA, 2003).

One of the challenges in local government in South Africa is the unclear lines of accountability. According to the Constitution (RSA, 1996), local government have both legislative and executive functions. This result in unclear separation of powers between municipal executive leaders (mayors) and the council in which they report. Furthermore, municipal powers are closely related to administrative functions that results in an overlap between political structures and bureaucratic systems. What further exacerbates the situation is that municipalities can choose from different governance models resulting in the possibility that the accountability framework can differ in almost every municipality. It is also reported that there are challenges in terms of insufficient accountability and flow of information between district -category B- and local municipalities – category C municipalities (The Conversation, 2018b). For the selection of case studies (also refer to section 6.3) cases included both category B and category C municipalities. Category A municipalities that comprise of Metro municipalities were not included as part of the cases selected because a category A municipality is not present in one of the provinces selected for this research.

It is within the context and structure of local government that the audit committee as part of governance is researched for this study. The next section briefly describes the role of the audit committee within the governance sphere. More comprehensive information of the specific roles and responsibilities of audit committees is provided in Chapter 4. The last section before the conclusion of this chapter describes the benefits of audit committees.

### **3.5 Role of audit committee and developments influencing audit committees within the governance sphere**

The audit committee is a key accountability instrument that plays a critical role in governance processes as demonstrated in the literature review in Chapter 2. To be able to evaluate the effectiveness of practice, practitioners, and praxis of audit committees in local government it is considered important to explore audit committees in the governance sphere and then specifically in the public sector and local government. This section starts of by presenting different descriptions of audit committees, followed by a brief overview of developments in the



role of the audit committee and then the role of the audit committee in public sector and local government.

Wayne (2003:5) describes the role of the AC, accepted by the Anglo-American regulatory community, 'To protect, ensure and enhance the integrity of financial reporting to stakeholders.

The objective of an audit committee is to assist the governing body to monitor the internal and external audit function and the accounting processes that can increase the credibility of the financial reporting process and ensuring control and compliance weaknesses are addressed resulting in improved accountability and oversight. (Beasley & Salterio, 2001:548; Hardiman, 2006:50).

Marx (2008:39-41) stated an overview of literature indicated the term 'audit committee' is not always formally defined but are usually described as part of the recommendations of codes and legislative requirements. He refers to some of the definitions and the development in the definitions between 1977 and 2007. The various definitions refer to the audit committee being a sub-committee of the board, consisting of the majority of non-executive directors and the responsibilities focusing mostly on dealing with financial reporting, audit, and internal controls.

Magrane and Malthus (2010:427) describe the aim of the audit committee to improve organisational governance and provide assurance on financial and compliance issues through increased scrutiny, accountability and the efficient use of resources, but also to provide advice on how to improve performance.

More recent definitions of the audit committee include:

"The audit committee is a key component of an organization's governance structure" (IIA, 2014:6).

The IIA (2014:4) consider audit committee to mean independent audit committee and describe the independent audit committee as:

"A public sector organization board-level committee made up of at least a majority of independent members with responsibility to provide oversight of management practices in key governance areas." <sup>43</sup>

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<sup>43</sup> The governance areas include values and ethics, governance structure, risk management, internal control framework, audit activity, external assurance providers, management action plans and financial statements and public accountability reports (IIA, 2014:5).

One of the most recognised speeches in the literature of audit committees was the speech by Arthur Levitt the Chairperson of the U.S. Securities and Exchange Commission (SEC) in 1998 when he stated: ‘... I believe qualified, committed, independent and toughminded audit committees represent the most reliable guardians of the public interest’ (U.S Securities and Exchange Commission, 1998).

Arthur Levitt initiated the nine-point action plan of which one point was to strengthen the audit committee process. This resulted in the SEC, the New York Stock Exchange and the National Association of Securities Dealers agreeing to sponsor the Blue Ribbon Committee (BRC) with the objective of improving the effectiveness of corporate audit committees. The BRC issued their report in 1999, and it is one of the most significant developments within the area of corporate governance related to audit committees. The BRC issued ten recommendations that can be grouped into three themes including strengthening the independence of audit committees; making audit committees more effective and improving the accountabilities of the AC, auditors and management (Abbott, Parker & Peters, 2004:70; Purcell, 2012:69). The BRC indicated their final recommendations were based on two essentials namely that the actual practice and overall performance of audit committees should mirror the professionalism of the board and a legal, regulatory and self-regulating framework with the emphasis on disclosure, transparency and accountability to be followed (Braiotta, 2004:11, 14).

The BRC Report was followed by the Securities and Exchange Commission (SEC) Rules (SEC, 2003:1999) aiming to improve the effectiveness of audit committees through the structure and composition of audit committees. Some of the recommendations contained in the BRC Report, for example on independence, was incorporated in the Sarbanes-Oxley Act, enacted in 2002, although it was not prescribed how director independence should be defined (Abbott et al., 2004:70).

However, in his summary on corporate collapses Marx (2008:63) states:

“...the mere existence of an audit committee is not a guarantee against corporate wrongdoing. Audit committees should not only exist in name but must be attentive and diligent in their workings to add real value to the company’s governance process and ultimately protect the shareholders and all stakeholders at large. As such these corporate collapses have had a significant impact on the refocused role of the modern audit committee.”

Purcell (2012:76) concurs and states effective governance assists the performance of any organisation. However, the critical governance factors relate to the diligence of the governing

body and the subcommittees including the audit committee and the level of transparency between management and the governing body.

The roles and responsibilities of audit committees continued to expand as reflected in the different codes of governance. In South Africa four Codes of Corporate Governance have been developed between 1994 and 2016.<sup>44</sup> The Codes of Corporate Governance in South Africa (King I, King II, King III and King IV), which is also applicable to the public sector, promotes the appointment of audit committees and describes their roles and responsibilities reflecting the expanding role of the AC. King I recommended the establishment of an audit committee with the focus on the independence of the AC. The first King report was followed by the second King Report that included a chapter on Board committees and included the composition, objectives and purpose, delegated authorities, tenure and reporting mechanism to the Board of the board committees including that of the audit committee in Appendix V (IODSA, 2002: 67-68). Under the responsibilities of the AC, Annexure V includes the traditional responsibilities associated with audit committees including the role in the appointment and evaluation of independence and effectiveness of external auditors and other requirements related to external audit (fourteen requirements); the review of the annual financial statements; the monitor of internal audit and effectiveness of internal control and monitoring the ethical conduct of the company and other ethics requirements (IODSA, 2002:187-190). The audit committee is required to make recommendations to the Board on matters arising from these responsibilities.

The King III devotes an entire chapter to the audit committee and has as one of the principles for the Board to ensure the company has an effective and independent audit committee (IODSA, 2009:30). The additional responsibilities in the King III include not only oversight of financial reporting but also sustainability reporting, monitoring the appropriateness of the combined assurance model, ensuring significant risks are adequately addressed and overseeing Information Technology (IT) governance (Price Waterhouse Coopers, 2009:2). The audit committee should also satisfy itself on the expertise, resources, and experience of the company's finance function (SAICA Legislation Handbook, 2011:63). Chapter three in King III stipulate the following requirements for the AC: the board to ensure the audit committee is effective and independent and that the audit committee composition is suitable in terms of skills and experience; the audit committee to be chaired by an independent non-executive

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<sup>44</sup> King Report on Corporate Governance for South Africa – also referred to as King I (IODSA, 1994); King Report on Corporate Governance for South Africa – also referred to as King II (IODSA, 2002); King Report on Governance for South Africa – also referred to as King III (IODSA, 2009); King IV Report on Corporate Governance for South Africa (IODSA, 2016).

member; oversee integrated reporting; ensure the combined assurance model is applied to provide for a co-ordinated combined assurance to all assurance activities; the audit committee to satisfy itself on the expertise; resources and experience of the finance function; oversee internal audit; form an integral part of risk management process; recommending the appointment of external audit and reporting to the Board how it has discharged its duties (IODSA, 2009:56-68). The need for the board and management to support the audit committee is also highlighted in the King III.

In the King IV report, the responsibilities of the audit committee is further expanded. The important role the audit committee plays to provide independent oversight of the effectiveness of the assurance functions and services with the emphasis on combined assurance are highlighted. Furthermore, the audit committee is not only required to oversee the integrity of annual financial statements, but also other external reports issued by the organisation. The King IV also require of the audit committee to disclose various matters including on the external auditors independence; significant annual financial statement matters considered and how addressed by the AC; views on the quality of external audit; views on the effectiveness of the CAE; views on the effectiveness of the design and implementation of internal financial controls; views on the effectiveness of the CFO and the finance function and the arrangements in place for combined assurance and the AC's view on effectiveness (IODSA, 2016:55-56).

Audit committees assume the important responsibility of representing boards of directors [councils in local government] on oversight matters related to financial reporting, auditing, and overall corporate governance. Audit committees are considered to be an important part of governance through the monitoring of management, the external auditor, and the internal auditor in an effort to protect shareholder's [stakeholders' interests] (DeZoort, 1997:208).

Spira (2003:182) describes committees as 'formalised groups, usually operating within a standardised framework of meetings with generally accepted practices relating to their structure, conduct and documentation (agenda, minutes, etc.), overlaid by local conventions of behaviour relating to the organisational context and culture within which they operate'. She then continues to describe audit committees as follows:

"The audit committee is a sub-committee of the main board of directors, with a remit covering issues relating to financial reporting, audit, and internal financial control. It has no decision-making powers and does not report directly to company shareholders. Its 'outputs' consist of reports and recommendations to the main board, offering assurance by providing formal evidence of its oversight activities. Its role is advisory and largely reactive: its work is often described using words such as 'monitor', 'review' and 'consider' " (Spira, 2003:182).

The perceived role of the audit committee is to undertake a detailed review on behalf of the governing body, to free up the time of the governing body and to ensure the expertise of the independent members are usefully employed (Spira, 2003:182-183).

The description by Spira (2003) resonates with the governance role of audit committees in local government, South Africa. Audit committees in local government is a sub-committee of the council that needs to provide advice to management and council on various matters including financial reporting, audit, and internal control. The audit committee reports to council, not the community and does not have any decision-making powers. The specific role and responsibilities of audit committees are further discussed in Chapter 4.

West and Berman (2003:330) in their study on audit committees in local government describe the role of audit committees in local government as follows:

“Audit committees oversee and monitor the financial accounting and auditing process, and also serve as a communication link between the city council, as representative of citizens, on the one hand, and the independent auditors on the other hand. Although the tasks of the audit committees vary, they are thought to be useful in enhancing the credibility of auditors, facilitating implementation of standards, improving the quality of audits, and ensuring accountability to citizens” (2003:330).

The description by West and Berman (2003) emphasises the role of the audit committee related to auditors. In South African local government, the role of the audit committee related to external audit (AGSA) is limited and further discussed in section 4.11.

Purcell (2012) in his thesis on effectiveness of audit committees in Victoria Local Government refers to effectiveness of audit committees as described by the Higher Education Funding Council of England. Although the Funding Council stated there was not a single measure of audit committee effectiveness that was universally applicable they described an effective audit committee as:

“... successfully supports the governing body to fulfil its responsibility for adequate and effective risk management, control, and governance and for the economy, efficiency, and effectiveness of the institution’s activities. This goes beyond simply meeting the criteria set out in the audit committee’s own terms of reference” (2012:79).

Purcell (2012:93) himself then states the effectiveness of audit committees in local government can be contingent upon the diligence of the councillors, the diligence and

expertise of independent members and level of transparency between management and members of council and subcommittees.

Purcell et al. (2014:340) state the independent variable being audit committee effectiveness can be partially explained by the dependent variables of assessment of authority and accountability; charter; membership; communication and reporting to council; quality of outcomes and training.

Relevant to the public sector in South Africa, National Treasury in circular 65 describe good governance to refer to how an organisation is managed, its organisational culture, policies, strategies, and the way it deal with stakeholders. According to circular 65 the internal auditor and audit committee provide objective, independent advice to improve oversight, governance and assist to mitigate risks (Purcell, 2012:2).

The following section presents the value added by audit committees.

### **3.6 Benefits of audit committees**

Audit committees form a critical part of corporate governance structures through their oversight and advisory role as reflected on in the literature review. The effectiveness of audit committees as part of the governance processes has also been very topical in research as reflected in the literature review and recognised by Turley and Zaman (2004 and 2007).

Studies have proven that effective audit committees are associated with stronger corporate governance (DeZoort & Salterio, 2001:32; Goh, 2007:24; Nashwa, 2005:42; Park, 1998:3) and entities with weak corporate governance characteristics including not having audit committees could be subjected to fraudulent reporting, manipulation of earnings and accounting errors (Abbott et al., 2000:55; Dechow, Sloan & Sweeney, 1996:1; DeFond & Jiambalvo, 1991:644; Farber, 2005:539; Marx, 2008:77; McMullen, 1996:87). Contrary to this, Beasley (1996:459) found audit committee presence is not significantly associated with the likelihood of financial statement fraud. Academics and professionals have consistently supported the use of audit committees as an oversight tool (AGA, 2008:5; David, 2009:45; Dechow et al., 1996:1; Deli & Gillan, 2000:427; IIA, 2014:6; Klein, 2002a:437; Menon & Williams, 1994:121 and Montondon, 1995:59;). Audit committees also have the potential to have a positive impact on the effectiveness and efficiency of auditing by reducing the auditor's perceptions of client business risk, the auditor's assessment of the control risks for specific audit assertions and the extent

of substantive testing (Cohen & Hanno, 2000:135). The IIA also recognises the significance of an audit committee for business and states effective audit committees assist the board and CAE in facilitating decision-making, implementing a system of risk oversight and management, and ensuring high-quality internal and external reporting (2014:6). In their theses, Strickland, Liu and Park, respectively, state that audit committees' oversight may strengthen fiscal accountability, accuracy and transparency of financial reporting and improve oversight of the audit of financial information (Strickland, 2011:10; 21; Liu, 2005:50; Park, 1998:4).

Turley and Zaman (2004:327) summarises the claims made in professional and governmental reports about the benefits of audit committees as part of corporate governance including: contributing to greater accountability, assisting directors to meet statutory and fiduciary responsibilities, creating a forum for role-players to deal with risk management, improvements in internal control structures, strengthen the position of internal auditors, playing a role in preventing and detecting fraudulent reporting and improving the quality of financial reporting.

In a study by Irwin (2009:45) on the perceived effectiveness characteristics of audit committees in the USA, the interviewees identified the following value added by audit committees: enhanced management accountability and accountability and transparency by component units; enhanced credibility of financial statements, management and internal audit and the finance department; authority; an independent forum that asks penetrating questions; extension of the governing body reducing the workload of the governing body and providing quality advice. Turley and Zaman (2007:783) concluded personal attributes of the audit committee combined with an organisational culture encouraging informal interactions between functional units and the audit committee seem to have significant influence on governance outcomes.

The American Institute of Certified Public Accountants (AICPA) identified five reasons why an organisation need an audit committee including: provide actionable insights to oversee and improve financial practices and reporting; create and maintain effective anti-fraud programs; enhance the internal audit function; oversee the organisation's external audit and strengthen credibility with stakeholders (AICPA, 2016a).

Benefits of audit committees in the public sector have also been recognised by various researchers and professional bodies. The benefits identified include the key role they play to enhance the integrity of the financial reporting, overseeing internal control and accountability, internal auditing, risk management and through the relationship with external audit and management resolve contentious issues related to financial reporting (David 2009:46-48;



Eckhart, Widener & Johnson, 2001:52-53; Hardiman, 2006:51; Nashwa, 2005:42). The importance of audit committees in the public sector was also emphasised in a position paper by the IIA and the Nix and Nix survey that highlighted the benefits of audit committees including effective oversight of financial reporting, auditing and internal controls; assurance of the independence of internal audit and that action is taken on the internal audit findings and enhancing communication between internal auditors, external auditors and management (Eckhart et al., 2001:53).

The AGA (2008) research paper included the following statement:

“The perceived benefits of governmental audit committees are many and varied, including improved accountability and transparency, quality advice on many topics, ‘clout’, an independent forum for resolving issues, extension of the governing board, ‘a third set of eyes’, insulating the internal auditor from undue pressure, increased credibility for the IAF and finance department, and improved communications of financial information” (2008:4).

The audit committee is also considered to be a practical tool for addressing financial oversight and internal control and can improve the financial management and overall governance of all types of government entities (AGA, 2008:4; Gauthier 2007:11).

The significance of governance for municipalities have increased significantly in the last three decades both internationally (AGA, 2008; Government Finance Officers Association (GFOA), 2008; West & Berman, 2003:330; Eckhart et al., 2001:52) and nationally.

In a municipal environment where, different from the private sector, inefficient financial management cannot be demonstrated by movement in the capital market and citizens are not necessarily good monitors of municipal finances because of the complexity of financial reports and the difficult in interpreting the information (Gore, 2009:6; West & Berman, 2003:347), the lack of effective monitoring by citizens can be compensated by having an effective audit committee that does it on behalf of the citizen. The audit committees can provide value adding services in their review of financial management and reporting. In contrast with shareholders of a private company the citizens do not perceive the risk of ineffective financial management as a direct threat to their well-being. The agency model in the public sector is further complicated by regulation in that information made public by municipalities are required by law and is not necessarily an indication that the municipality is effective or are managing the finances effectively. Strickland (2011:13) states that relational attributes or the perception of risk or regulation could prevent or substitute the benefits of effective monitoring.



It is not a prerequisite for councillors to have technical knowledge of financial management and reporting, performance management and legislation. Councillors are reliant on the guidance and information provided by the MM and senior management. However, the levels of assurance provided by the MMs and senior management was found to be very low (only 22% provided the required level of assurance) and the Auditor-General recommended that municipal public account committees and audit committees need to be strengthened (Auditor-General, 2015:111). The audit committee need to contribute to effective assurance by assisting councillors and management in providing advice and oversight on governance related areas.

In the South African local government, it is a legislative requirement to appoint audit committees. As part of this research it was considered important to investigate the scientific results proving the benefits of audit committees within the local government context. Table 3.3 demonstrates the link between positive audit outcomes and assurance<sup>45</sup> provided by audit committees (AG, 2015:17).

The Auditor-General reported the audit committees of 61% of the auditees had a positive impact on the audit outcomes and assurance of 87% was further enhanced through interaction with the mayors and councils to share information and risks (Auditor-General, 2015:102).

The Auditor-General as part of the recommendations concluded that governance of municipalities was significantly improved by well-functioning audit committees and where councils and management implemented the recommendations of audit committees (Auditor-General, 2016:18).

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<sup>45</sup> The description by the Auditor-General in the 2015 consolidated general report on the audit outcomes of local government: 'assurance is a positive declaration that is intended to give confidence in the credibility of financial and performance reports tabled by auditees and in the extent to which auditees have adhered to applicable legislation.' The Auditor-General also identify role players in local government (assurance providers), other than the external auditors, that are required to contribute to assurance and confidence by ensuring that adequate internal controls are implemented to achieve auditees' financial, service delivery and compliance objectives. The assurance providers identified by the Auditor-General include senior auditee officials, various committees (for example, municipal public accounts committees, performance, and audit committees) and internal audit units. Other role players that should provide assurance further include oversight structures and coordinating or monitoring departments (AG, 2015:194). 'Oversight structures consist of the provincial legislatures, the portfolio committees on local government and the National Council of Provinces. Coordinating or monitoring departments include the Department of Performance Monitoring and Evaluation, the National Treasury and provincial treasuries, the national and provincial departments of cooperative governance as well as the offices of the premier' (AG, 2015: 198).

**Table 3.3: Link between positive audit outcomes and assurance provided by audit committees**

<b>Audit outcome</b>	<b>Assurance provided by audit committee</b>
Clean <sup>46</sup>	At 98% of the auditees audit committees provided full assurance
Unqualified with findings <sup>47</sup>	Auditees where audit committees provided full assurance were limited to 39%
Qualified with findings <sup>48</sup>	8% of audit committees provided the required assurance and audit committees had not been established at 8% of the auditees
Adverse <sup>49</sup> or disclaimed <sup>50</sup> with findings	6% of the auditees did not have audit committees while the audit committees at 65% provided limited or no assurance

The literature and the results of this research underscores the value of audit committees and structures to strengthen the constitution on local government levels and the positive effect it can have on governance policy conceptualisation, design and implementation related to audit committees in the public sector and local government.

### 3.7 Conclusion

This chapter begins with various descriptions of the meanings of corporate governance. It is followed by sharing the principles and values of [corporate] governance focussing on the public sector and the important link between corporate governance and accountability. As part of the information on the principles, the link between the principles of governance and the role of the audit committee are demonstrated. The chapter briefly reflects on the development of corporate governance by referring to the various King governance codes issued in South Africa. Following the description, principles, and value, the different role-players including the

<sup>46</sup> 'The financial statements receive a financially unqualified audit opinion and there are no material findings on the quality of the annual performance report or compliance with key legislation' (Auditor-General 2015:195).

<sup>47</sup> 'The financial statements contain no material misstatements. Unless we express a clean audit opinion, findings have been raised on either the annual performance report or compliance with key legislation, or both these aspects.' (Auditor-General, 2015:196). Material misstatements are an error or omission that is significant enough to influence the opinions or decisions of users of the reported information. Materiality is considered in terms of either its rand value or the nature and cause of the misstatement, or both these aspects (Auditor-General, 2015:198).

<sup>48</sup> 'The financial statements contain material misstatements in specific amounts, or there is insufficient evidence for us to conclude that specific amounts included in the financial statements are not materially misstated.' (Auditor General, 2015:199).

<sup>49</sup> 'The financial statements contain misstatements ... that are not confined to specific amounts, or the misstatements represent a substantial portion of the financial statements' 'Misstatements are incorrect or omitted information in the financial statements or annual performance report' (Auditor General, 2015:194-198).

<sup>50</sup> 'The auditee provided insufficient evidence in the form of documentation on which we could base an audit opinion. The lack of sufficient evidence is not confined to specific amounts or represents a substantial portion of the information contained in the financial statements' (Auditor General, 2015:196).

mayor, councillors, management, and internal audit who form part of [corporate] governance in the public sector is discussed. It is then narrowed down to the specific part audit committees play in the *eseke/we* of [corporate] governance in the public sector and local government including the developments that influenced this. To provide context for this study the municipal structure and the key pieces of legislation affecting local government including the Local Government Municipal Structures Act (RSA, 1998), the Municipal Systems Act (RSA, 2000a), and the MFMA (RSA, 2003) are referred to and briefly reflected on. The chapter concludes with the contributions the audit committees make to corporate governance.

The following chapter analyses the different roles and responsibilities for which audit committees are responsible.

## CHAPTER FOUR: ROLES AND RESPONSIBILITIES OF AUDIT COMMITTEES IN LOCAL GOVERNMENT

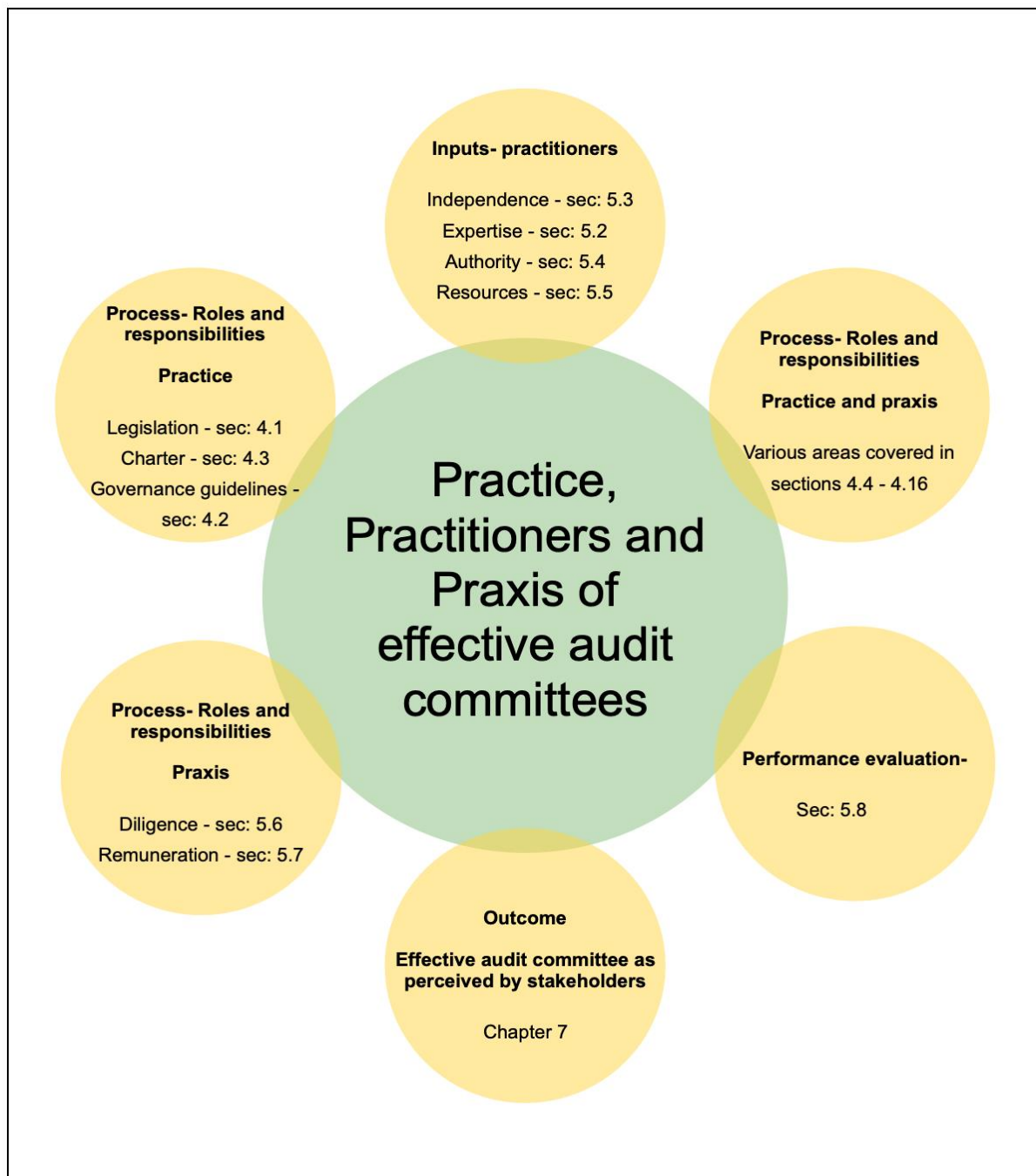
### 4.1 Introduction

The objective of this chapter is to show the results of the study on the roles and responsibilities of audit committees in South African local government. The examination of the roles and responsibilities contributes towards the key research objective of determining the practice, practitioners, and praxis associated with effective audit committees in local government. The body of knowledge obtained through the study of roles and responsibilities prescribed in legislation, corporate governance codes and guidance documents also informed the investigation of a possible disjuncture between audit committees' requirements in terms of legislation and best practice and governance stakeholders' expectations.

The chapter starts by discussing the legislative role of the audit committee, followed by describing the role and responsibilities contained in the King IV corporate governance code. The importance and content of the audit committee charter in defining the roles and responsibilities of the audit committee and the advisory versus oversight role of the audit committee is also covered in this chapter. The chapter then continues with an analysis of the different specific areas of responsibility.

The local government sector is highly regulated with various role-players involved in the monitoring process as reflected in Chapter 3. This chapter analyses and reflects on the various roles and responsibilities of the audit committee specifically.

The following roadmap of Chapters 4 and 5 categorises the various roles and responsibilities and determinants of effectiveness in line with the theme of this thesis, being the practice, practitioners, and praxis of effective audit committees based on the input-process-outcome model.



**Figure 4.1. Roadmap linking chapter sections to thesis categories and input-process-outcome model**

## 4.2 Challenges and development in audit committee responsibilities

Much criticism has been raised against audit committees and their effectiveness in fulfilling the expected roles and responsibilities. Some of the earlier criticism includes a lack of technical skills (DeZoort, 1997:208; Kalbers, 1992a:27 and 1992b:44; Lee & Stone, 1997:98),

a tendency not to recognise assigned responsibility (DeZoort, 1997:208), lack of auditing and internal control evaluation experience (DeZoort et al., 2002:41), and the lack of information from management and internal and external auditors (Marsh & Powell, 1989:55). In response to the criticism, various studies and recommendations on additional duties and responsibilities for audit committees have been completed (Iskander & Chamlou 2000:99; Wayne 2003:39) and formed part of the literature review presented in Chapter 2.

Criticism against the effectiveness of audit committees was also expressed by chief audit executives (CAEs) (the heads of IAF's) in a survey of 32 local authorities in Scotland. The CAEs found audit committees less effective overall when compared with the views of the CFOs and ACC. The CAEs also indicated the likelihood of the audit committee causing conflict. A possible explanation for the perceptions of the CAEs is the disappointment of the CAE in the contribution by the audit committee to ensure that the IAF is understood and respected throughout the council. Another reason for the perceptions can be ascribed to the additional reporting requirements imposed on internal audits (Crawford et al., 2008:213). In South Africa, criticism against the audit committees was also expressed by the Auditor-General (AGSA, 2015:13; AGSA, 2017:13).

DeZoort (1997:214) in early research used the 17 prescribed audit committee objectives identified by Wolnizer (1995) in the areas of accounting and financial reporting, auditors and auditing, and corporate governance in general to assess audit committees' abilities to recognise their assigned objectives. The Wolnizer (1995: 47-48) list of objectives is used by DeZoort (1997:214) because it is a comprehensive list of responsibilities based on various authoritative sources and is presented in Figure 4.2. Audit committee members considered internal control evaluation to be the most important oversight responsibility (DeZoort, 1997:208).

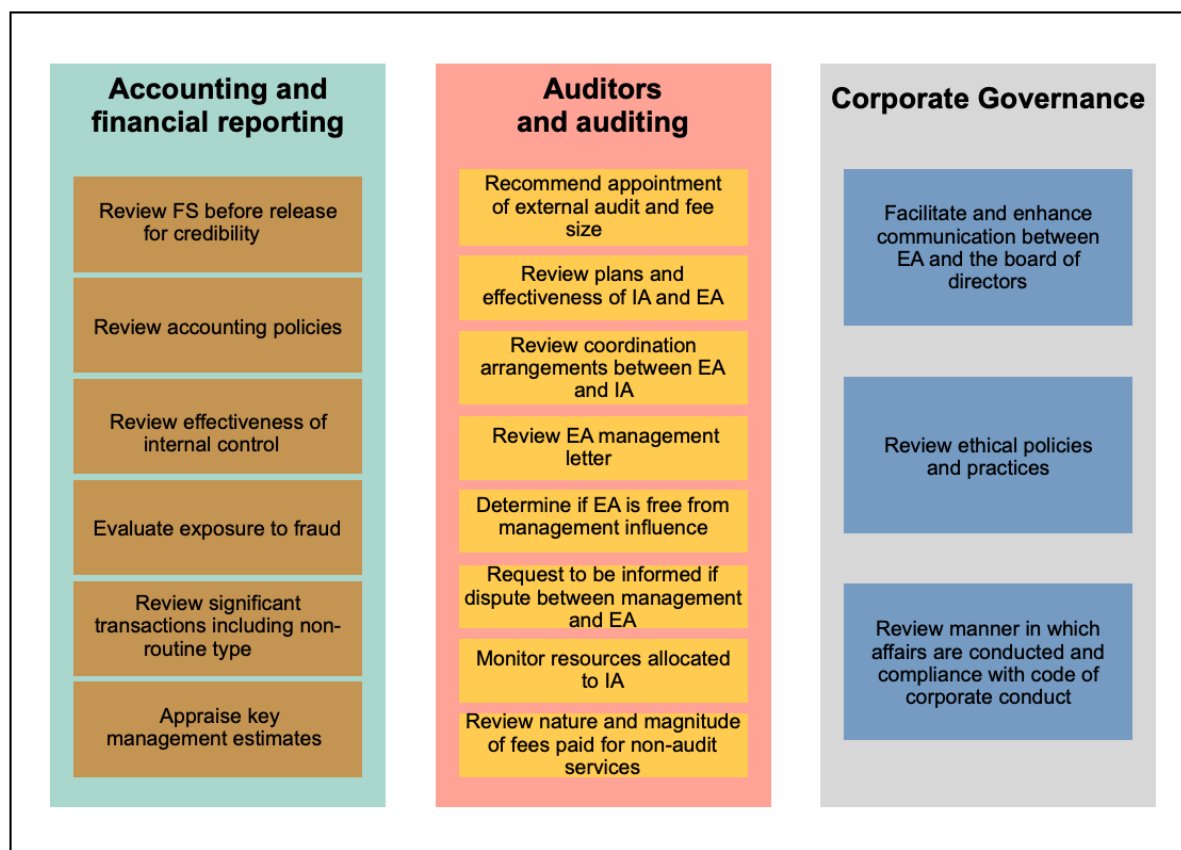
DeZoort et al. (2002:40) indicate that many publications prescribe the broad areas of audit committee oversight to include financial reporting, internal controls to address key risks, and auditor activity. As demonstrated in this chapter, the roles and responsibilities have expanded considerably since the research by DeZoort et al. (2002:40).

The literature review reveals that the roles and responsibilities of audit committees in the private<sup>51</sup> and public sector have evolved and expanded considerably over time (Giles, 1998:3;

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<sup>51</sup> Wayne (2003:13) recognises that the audit committee's role initially was narrowly defined to manage the relationship between the external auditor and management. The role expanded to include ensuring quality accounting policies, reliability of internal controls, and independent and objective external auditors. The six tasks

Marx, 2008:2; Millstein 1999:1063; Singhvi 2011:vi; and Turley & Zaman 2004:306), resulting in sometimes unrealistic expectations by some of the stakeholders (Mohamed & Hussain 2005:42). Magrane and Malthus (2010:441) found that audit committees served different roles under different circumstances including being a threat, a mediator, or an ally. According to Rittenberg (2016:2) the AC's role has evolved from a narrow focus on financial reporting and external auditing to a broader mandate covering risk management, internal controls, compliance, whistle-blower processes, cybersecurity, and internal auditing.



**Figure 4.2. Audit committee objectives identified by Wolnizer** (Wolnizer, 1995:47-48).

DeZoort et al. (2002:65) in the identification of future research directions pose the fundamental research question that has not been answered:

Can the audit committee ever hope to meet the expectations placed on it by various stakeholders and actually achieve ACE [audit committee effectiveness] given its current structure (e.g., part-time limited resources)?

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identified by Wayne include: 1) ensuring the external audit is independent of management; 2) ensuring the external auditor is accountable to the audit committee; 3) ensuring the internal audit is accountable to the audit committee; 4) ensuring there is an effective and comprehensive system of internal controls; 5) ensuring quality financial accounting policies and financial reporting; and 6) ensuring it receives complete and reliable information (Wayne, 2003:17-18). For this research, only items 3 – 6 are relevant in South Africa because of the independence of the Auditor-General in South Africa, being the external auditor.



Wayne (2003:25) in his thesis on the determinants of the effectiveness of audit committees summarised this by stating ‘...initially tasks are met by *making inquiries, relying on other, reviewing or waiting to be advised of a problem*. This is a passive or non-technical approach.... As time progressed, the audit committee has been asked to fulfil the tasks by *ensuring, making certain, assuming responsibility, or holding others accountable*. Wayne (2003:35) refers to the active approach to task fulfilment as consistent with an agency role of monitoring and controlling management. According to Wayne, the role has changed from ‘oversight’ to ‘ensuring’.

The continuous changing role and increased expectations has recently been evident in the outbreak of the COVID-19 pandemic. Risks to be considered by the audit committee have been identified to include unmanaged infection risk, disruption of service risk, inadequate facilities to allow social distancing measures, insufficient budget to manage COVID 19 related activities, inadequate ICT equipment for the ‘virtual office’, limited information on the COVID 19 pandemic and regular changes in regulations compliance risk. In response to the changed environment should review the revised risk management registers, incident response plan, business resumption plan, health, safety and wellness plan, the pandemic awareness strategy, the compliance plan, the revised ICT strategy and the revised internal audit plan (IIA, 2020:3-4). IFAC (2020) has also issued a document to guide audit committees and indicate issues to be at the top of mind for audit committees include monitoring the financial reporting implications and a renewed focus on the strength of the balance sheet, third-party risk management and ensuring comprehensive business continuity thinking and monitoring and maintaining an effective internal control environment with due regard to increased cyber security and data privacy issues, displacement of staff and potential for increased risk of fraud due to financial pressures.

Within the evolving and changing environment in which the audit committee operates, it is especially important that the audit committee and all stakeholders have a clear understanding of the rights, duties, and responsibilities of the AC. According to Marx (2008:3), it is important for the board to understand and respect the role, position, limitations, and responsibilities of the audit committee and not see the audit committee as a burden or the expert in all respects. It is also important for the audit committee members to understand their roles, responsibilities, limitations, and importance. All other stakeholders that interact with the audit committee including management, external, and internal auditors must also have a clear understanding of the roles and responsibilities.



One of the challenges for audit committees highlighted in the research problem section is unclear accountability, role clarity, and reporting lines. To inform the research on audit committee roles and responsibilities, it is necessary to refer to the roles and responsibilities prescribed in legislation and other authoritative documents and applied in practice. The next section analyses the prescribed roles and responsibilities of audit committees within local government starting with the role prescribed by legislation and related guideline documents in South Africa. But firstly, I want to share a part of my story.

### My story

So, what is it that audit committees do?

I remember this discussion with my daughter about serving on audit committees. She was about five at that time:

Daughter: Where are you going mom?

Me: I am going to an audit committee meeting.

Daughter: What do you do at an audit committee meeting?

I was in quite a hurry at the time not to be late for my meeting and tried to give her the quickest answer possible.

Me: I make sure people do what they are supposed to do.

Daughter: What are they supposed to do?

Me: They must make sure the money that people pay for taxes are being used for the right reason and that they keep record of it.

I could see by then she was losing interest and because I was quite anxious to get going I did not bother to try and explain better or differently.

Since that short discussion on what audit committees actually do I have often reflected on my explanation and realised it didn't do justice at all on what audit committees do.

I also realised there has been a significant involvement and expansion in the role of audit committees over the years. Yes, in the beginning when I started, it might have been very much an oversight role, making sure people do what they are supposed to: implement internal controls, implement recommendations by internal and external audit, and review the financial statements.

I also believe there are sometimes unrealistic expectations by various role-players in how much audit committees can do given their available time and other working priorities. I

have come to the realisation that audit committees serve different roles under different circumstances and, as so correctly described by Magrane and Malthus, can be a threat, a mediator, or an ally.

During my reflection of that early discussion with my daughter, I also thought whether my answer would differ if she had to ask me that same question now. It most definitely would!

Me: I am going to the meeting to help the people working at the municipality, and the people making sure that the money we all pay for our taxes are used correctly, through their work to make it easier and better and to help them to make better decisions and do the right thing.

### 4.3 Audit committees' legislative role

Within the municipal context, the Municipal Structures Act (117 of 1998), (RSA, 1998), Local Government Municipal Systems Act (32 of 2000) (RSA, 2000), and the MFMA (56 of 2003) (MFMA) (RSA, 2003) comprise the key legislation that regulate the internal systems and structures to secure sound and sustainable financial accountability and management of municipalities. The audit committee is a sub-committee of the council in local government. This section therefore includes a brief introduction to the legislative power, while the roles and responsibilities of council before the power and roles and responsibilities of the AC, as sub-committee of council, are further described.

In terms of sections 157, 159, and 160 of the Constitution of the Republic of South Africa, council consists of directly elected members by the municipal electorate and proportional representation assigned by political parties on the basis of each party's number of votes and are elected for a period of five years. The municipal council is a key structure responsible for decisions concerning the exercise of all the powers and the performance of all the functions of the municipality. The Constitution (RSA, 1996), in section 160 (1), vests the municipal council with the authority to elect an executive committee and other committees subject to national legislation. To give effect to section 160 (1) of the Constitution (RSA, 1996), the Municipal Structures Act (RSA, 1998) makes provision for the establishment of various types of committees. Section 33 of the Act sets out the criteria<sup>52</sup> for the establishment of a committee to act on behalf of council, thereby enabling councillors to engage meaningfully with municipal governance issues. Section 79 (1) of the Act makes provision for the establishment of committees including council committees from among the council members and the dissolution of a committee at any time. Section 79 (2) requires of the council to determine the functions of the committee, allow council to delegate duties and powers to the committee, compel council to appoint the chairperson, authorise a committee to co-opt advisory members who are not members of the council, allow for the removal of a member of a committee at any time and may determine a committee's procedures (RSA, 1998).

The Local Government: Municipal Systems Act (32 of 2000) (RSA, 2000) includes an entire chapter on performance management (Chapter 6) and allows for the Minister in section 49 to make regulations or issue guidelines on various performance related matters. Subsequently, in 2001, the Municipal Planning and Performance Management Regulations (RSA, 2001b)

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<sup>52</sup> Criteria include municipality type allowing for committees, the necessity of the committee, functions and powers of the committee and need for delegation to ensure efficiency and effectiveness, availability of financial and administrative resources, and the municipality having more than nine councillors.

was issued which included the requirement for a municipality to annually appoint and budget for a performance audit committee consisting of at least three members, the majority of whom may not be involved in the municipality as a councillor or an employee. It is further required that at least one person on the performance audit committee has expertise in performance management (RSA, 2001b) section 2 (a and b)). Section 2 (c) of the Regulations allows for the audit committee to also fulfil the role of the performance AC. Based on observations in practice, the use of the audit committee to fulfil the responsibilities of the performance audit committee is a regular occurrence.

Sections 166 (1) and (4) of the MFMA (56 of 2003) (RSA, 2003) requires each municipality to have an audit committee that comprises of at least three persons with appropriate experience who are not in the employ of the municipality or municipal entity. Section 166(5) of the MFMA requires that the council of the municipality appoint the AC. The role of the audit committee includes advising the municipal council, political office-bearers, accounting officer, and the management of the municipality or municipal entity on matters relating to internal financial controls and internal audits; risk management; accounting policies; the adequacy, reliability, and accuracy of financial reporting and information; performance management and effective governance; compliance with the MFMA, the Annual Division of Revenue Act, and any other applicable legislation; performance evaluation; and other issues referred to it by the municipality and municipal entities under its sole control (RSA, 2003). Demonstrated in this chapter, the audit committees' roles and responsibilities extend above the legislative requirements.

In 2012, National Treasury issued circular 65 to provide information to assist municipalities to improve the effectiveness of the IAF and audit committees. The circular was issued to provide additional guidance on the two crucial components of corporate governance in municipalities, namely internal audit, and the AC, as these government components are required by the MFMA (National Treasury, 2012:1). Through interviews with the various stakeholders, this study determines the extent of the perception that audit committees fulfil their legislative roles and responsibilities, the results of which are reflected in Chapter 7.

The framework for governance of organisations, according to King IV, comprises of applicable legislation, the King IV principles, and King IV practices. Applicable legislation sets the minimum standards to be complied with and was covered in section 4.3. The framework recognises that if King IV sets the bar higher than the minimum legislative requirements, organisations should strive to comply with the higher requirements in the interest of sound governance. The King IV principles are relevant to all organisations and guide what the

organisations should strive for to achieve good corporate governance. The King IV practices should be adapted to meet the challenges of the relevant sector, situations, and legislative regimes (IODSA, 2016:76). In the next section, the King IV principles, and practices for audit committees in local government are discussed.

#### 4.4 Role described in the King IV Code on Corporate Governance

Principle 8 of King IV provides guidance to committees of the governing body and states that the governing body should ensure its delegation arrangements within its own structure promotes independent judgement and assists with the balance of power and the effective discharge of its duties (IODSA, 2016:54).

King IV describes the role of the audit committee to provide independent oversight of, among others:

- a. the effectiveness of the organisation's assurance functions and services, with particular focus on combined assurance arrangements, including external assurance service providers, internal audit, and the finance function; and
- b. the integrity of the annual financial statements and, to the extent delegated by the governing body, other external reports issued by the organisation.

King IV requires that 'the audit committee should oversee that implementation of the combined assurance model results in combining, co-ordinating and aligning assurance activities across the various lines of assurance, so that assurance has the appropriate depth and reach' (IODSA, 2016:21). Part 6 of King IV contains sector supplements to provide guidance on how King IV should be interpreted and applied by different sectors. One such sector supplement pertains to municipalities. The sector supplement clarifies the reconciliation of legislation and King IV by stating that applicable legislation sets the minimum standard and that sound governance goes beyond legal compliance. In the interests of sound governance, King IV sets a higher standard when compared to legislative requirements and organisations should strive to achieve the higher standards (IODSA, 2016:1). In this regard, the supplement makes specific mention of the practices recommended in the Code as they relate to the duties of the audit committee in enhancing legislated duties.

The next section describes the terms of reference, also referred to as audit committee charter, being a key document to assist audit committees to focus on their required roles and

responsibilities, which also serve as a tool to the governing bodies to assess the performance of the audit committees.

## 4.5 Audit Committee Charter

The importance of an audit committee charter is highlighted in different studies (AGA, 2008:4; Hardiman, 2006:51; IIA, 2014:8; National Treasury, 2012:3 and Porter & Gendall, 1998:49).

Hardiman (2006) states the following:

“As an empowered advisory body, a public sector audit committee should have a written charter setting forth its purpose, authority, and responsibilities. The charter and bylaws should also define the committee’s organizational structure, identify desired qualifications of committee members, and prescribe member terms, voting and governance requirements, and timetables. Finally, the charter and bylaws should be goal oriented and not so specific as to be restrictive” (2006:51).

Nashwa (2005:43) states that an audit committee should have a charter that states its mission, objectives, authority, organisation, and methodology. Nashwa further indicates that the charter should include voting requirements, the liability of members and their method of appointment.

The AGA (2008:4) identified the most important best practice for government, is to adopt a well-thought out, complete charter for the audit committee that includes clearly defined objectives, committee responsibilities, and committee membership.

The importance of documenting roles and responsibilities in a charter is also recognised in South Africa in King IV which requires the governing body to document its roles, responsibilities, membership requirements, and procedural conduct in a charter to guide the effective functioning (IODSA, 2016:49). It further requires the governing body to disclose whether it is satisfied that it has fulfilled its responsibilities as per the charter for the reporting period (IODSA, 2016:49). To the extent that the governing body delegates certain functions to the AC, it is required that delegation to audit committees, roles and responsibilities, membership requirements, and procedural conduct should be documented in a formal audit committee charter that should be annually approved and reviewed by the governing body.

According to Circular 65, the audit committee operates as a committee of council and must perform its legislative duties (section 4.3) and the corporate governance responsibilities included in the charter by the council. The circular describes a charter as ‘... the written terms

of reference approved by the council which outlines the mandate of the AC. The charter becomes the policy of the audit committee which then informs the contracts of the audit committee members' (National Treasury, 2012:3).

The Audit Committee Charter, when approved, will provide the written authority for the audit committee to fulfil their roles and responsibilities effectively. Circular 65 on internal audit and audit committees states a clear, well-written charter should set out the objectives, roles and responsibilities, composition, structure and membership requirements, relationships with other stakeholders, authority for the committee to conduct enquiries and access records and personnel, outline procedures for meetings, address confidentiality and independence of audit committee members, and provide for ethical conduct and reporting. The circular further recommends that after approval, the audit committee charter should be published on the municipal website to promote awareness among stakeholders (National Treasury, 2012:3). The audit committee charter should be reviewed annually and updated to ensure relevance and consistency with legislative requirements and best practice (National Treasury, 2012:3).

The IIA describes elements to be included in the audit committee charter to include the mandate, membership requirements, authority and responsibilities and process for developing, reviewing, and updating the charter. The charter should also address the key concept of independence (2014:5).

Circular 65 describes the purpose of the audit committee charter to be used as a basis to prepare the AC's annual work plan, set the agenda points for the meetings, make recommendations to the MM and council, and guide areas where contributions and participation at meetings can be made. The charter can also be used as a monitoring tool to assess the performance of audit committee members by the members, council, management, Auditor-General, and internal auditors (National Treasury, 2012:3). The performance evaluation of audit committees is further described in section 5.10.

As part of this research, the audit committee charter for each of the audit committees selected in the sample were reviewed against the criteria included in this section and the results are set out in section 7.4.1.1.

DeZoort et al. (2002:58) indicate the lack of research in identifying the ultimate source of the audit committee authority and the association between the effectiveness of audit committees and audit committee authority. In local government, the authority of the audit committee is determined by council in compliance with the legislation, however, in practice it is unclear how



the authority is provided and supported. This research investigates this further through analysing the authority reflected in section 5.6 and by way of interviews with the different role-players and described in Chapter 7. The purpose of the next section is an attempt to further clarify the roles and responsibilities of the audit committee by discussing the differences between an oversight versus an advisory role.

#### 4.6 Oversight vs advisory role

It is necessary to analyse the differences (if any) between oversight and advisory because it has been a specific point of discussion raised at one of the audit committees the researcher was involved with and was raised at various of the Public Sector Audit Committee Forum as an area where clarity was sought by audit committee members in local government. The literature review revealed that the agency theory has been the dominant theory used in research on corporate governance (section 2.2.1) with the result that much emphasis was put on the monitoring and oversight role of audit committees, these terms being used interchangeably. Based on the analysis of the legislative requirements, it is apparent that the audit committee within local government needs to fulfil an *advisory role*. However, throughout the literature reference is made to the *oversight role* of the AC. It is necessary to establish, for role clarity purposes, whether there are differences between monitoring and playing an oversight or advisory role.

Recent research by Cullen and Brennan (2017) analysed the differences between control, monitoring, and oversight in the context of investment fund boards. Although this thesis focusses on local government the analysis of the terms control, monitoring, and oversight by Cullen and Brennan proved useful for this research. According to Cullen and Brennan (2017:1867), the terms ‘monitoring’ and ‘oversight’ are often used interchangeably although they differ in the level of influence implied in each. According to the researchers, monitoring involves direct review/observation of management performance and may be accompanied by consequences where performance is inadequate (Cullen & Brennan, 2017:1883). Oversight, on the other hand, is described as ‘keeping a watchful eye’ and ‘acting on behalf of shareholders [council]’ and oversight being a weaker term than monitoring, being an indirect action (Cullen & Brennan, 2017:1884). Through oversight, one cannot take direct action but can obtain consequences through another party. Relevant to this research, the audit committee acts on behalf of council, according to the responsibilities set out in the audit committee charter, approved by council, and report any significant matters to the council for it to take the necessary action, thereby fulfilling an oversight role.

Earlier research by Brennan and Kirwan (2015:476) also reflects the over-emphasis on the monitoring role of the audit committee because of the influence of the agency theory, with the result that an expectation gap occurred between the function, power, and influence of audit committees (2015:476). Brennan and Kirwan (2015:476) recognise the terms monitoring and oversight are often used interchangeably and collectively to describe the role of the AC. They also argue there is a difference depending on the level at which it is applied. According to them, oversight is a weaker term than monitoring and relates more to the work the audit committee does given their advisory and support role. Brennan and Kirwan (2015:476) ask: 'What is the role of the audit committee – blamist tool or supportive of improvement?' (Brennan & Kirwan, 2015:476).

The IIA refers to the audit committee playing an independent oversight and advisory role but emphasises the importance of the responsibility for decision-making resting with management (IIA, 2014:6). During the fieldwork, some participants went to great lengths to state the role of the audit committee should be advisory and that the audit committee should not interfere with management's decision-making or management of the municipalities and even provided examples where the audit committee attempted to get involved with management decisions regarding human resource related matters.

According to definitions, oversight refers to 'supervision' (The Readers Digest Association, 1972) or 'the action of overseeing something' and an oversight committee being 'a committee appointed to supervise or inspect government operations' (Lexico). Advise means to offer counsel to, offer advice and recommend (The Readers Digest Association, 1972), caution or warn, recommend, counsel (Webster, 1971), and implies that the giver of the advice has knowledge or experience (Collins Dictionary). The legislative requirements for the audit committee are to advise the municipal council and management of the municipality on various matters including internal financial controls and internal audits, risk management, accounting policies, the adequacy, reliability and accuracy of financial reporting and information, performance management, and effective governance. In agreement with Brennan and Kirwan (2015:476) oversight is the work the audit committee does given their advisory and support role culminating in advice to council and management to improve processes and systems.

Erasmus and Matsimela (2018:1) researched the oversight versus advisory role of the audit committee in local government and concludes of a possible governance anomaly in the legislation. The interpretation and perception of the oversight and advisory role of the audit



committee have been further explored during the interviews and the results are set out in Chapter 7.

### **My story**

Based on my own experience, the role of the audit committee has evolved from being mostly an oversight and monitoring role (in accordance with the agency theory) to being a much more of an advisory role. I started serving on my first audit committee meeting in approximately 2000. Although this was not at a municipality, it was at a public entity in government. I left the auditing firm where I completed my training and a few additional years of work. It was a requirement for the public entities to have an audit committee and my ex-firm was at the time the external auditors of the public entity. I was approached to serve on the audit committee which I accepted as I considered this to be a new challenge and 'learning experience'. It was indeed totally new to me and quite intimidating. I was young and although I had very good experience in dealing with clients, sometimes very difficult clients, this was a totally new environment. Here I was sitting in a big boardroom, with the Chief Executive Officer and other executive managers and my perception then was that I had to make sure they had controls in place to ensure the integrity of financial information. How on earth do you tell them if these controls are not adequate? How do you make sure you identify all those internal controls not in place? Do you solely rely on the information given to you by internal audit? All those thoughts regularly crossed my mind, and I was not always sure that I had the experience to adequately fulfil my role.

Interestingly enough, during the fieldwork (20 years after serving on my first audit committee, and being very inexperienced) a mayor at one of the municipalities raised a concern that one of the qualifying criteria for the appointment of audit committee members is the need to have experience in local government. He used an example of appointing a young chartered accountant with very little experience in local government, despite the emphasis on having to have municipal experience and indicated this proved to be a very good appointment where this young, inexperienced person is adding a lot of value to the audit committees' contribution to the municipality. This made me feel a lot better and hopefully I also added value during my early, inexperienced days. It is not easy to reflect on this and my own potential shortcomings in serving on audit committees. As stated by one of the participants during the fieldwork: '... but in a lot of cases you actually do have a lack of some specialist knowledge. But then I think also audit committee members do not want to admit that'.

However, I digressed from the topic of oversight versus advisory and the evolvement. If I recall serving on audit committees in the early days, the style of interrogation by audit committee members and the type of questions asked took the form of 'supervise' rather than 'recommend'.

It was also evident while attending and being a speaker at the Public Sector Audit Committee Forums during the period 2014 to 2016 based on the questions asked and debates that many audit committee members felt they could not fulfil their oversight responsibilities because they do not have the power or 'teeth' to enforce their recommendations. The following quote by the MM at MUN6 refers to this perceived lack of power.

*Because I remember just from an experience in the previous municipality with the audit committee that we had there, they felt that they should have more power, and didn't have enough teeth. They wanted more, a type of investigations and all of those things which in my view is not really the point. Advisors should say I'm not happy with this and this, I think we need to have more investigations into this matter ...*

However, I have experienced that over time, the attitude of audit committee members has changed in the local government environment. At one of the municipalities, I served as an audit committee member, this became quite a contentious issue where management challenged the audit committee and emphasised the advisory role rather than the 'supervisory role' to be played by the audit committee. During the fieldwork, the participants' views on advisory versus oversight role was also obtained and are further discussed in Chapter 7.

The rest of the sections in this chapter provide information on the different audit committee responsibilities. Traditionally, and reflected in the literature review, the key functions of the audit committee include the review of financial accounting policies and review of financial statements (section 4.7), oversight of internal audit (section 4.8) and external audit (section 4.11, and review of internal control (section 4.9).

## 4.7 Role within the financial accounting policies and reporting environment

Traditionally and currently one of the most important roles and responsibility of the audit committee is the review of the financial statements, including oversight of the financial accounting policies and financial reporting environment (DeZoort, 1997:224).

Although, as indicated in Chapter 2, most research focuses on the private sector, the importance of relevant and reliable financial information for appropriate decision-making and improved fiscal policy within government have been recognised by various researchers. Fink (2008:3) and Torres (2004:447) reports on continuous efforts made across the world to improve the relevance and reliability of financial reporting and financial accountability within government. Examples where reliable and relevant financial information is essential include government budgeting where decisions on how the taxpayers' money should be spent are taken (Rubin, 1990:180). Another important source of financial information is the annual financial statements that provide a historical view of financial activities. Through budgeting and audited financial statements, government can answer to the public administration on issues of accountability and trust, contributing to good governance.

Rittenberg and Nair (1993:41) studied the activities of effective audit committees and reported that management control and reporting system are the two top priorities for audit committees and include reviewing the adequacy, completeness, and fairness of management's financial reporting and evaluating the adequacy of financial statement disclosures.

Extensive research on either the effect of the AC's presence or absence on financial reporting quality<sup>53</sup> or testing the mechanisms and characteristics,<sup>54</sup> for example meetings, independence, and background on financial reporting quality have been completed. Turley and Zaman (2004:318) state that it is difficult to identify signs of financial reporting quality but it can be attempted by analysing actual figures, for example, if the audit committee improves the company's earning quality or through negative signals of problems in financial reporting for example instances of errors, fraud and irregularities, relevant to this research as indicated as part of the research problems with reference to the Auditor-General findings. The earlier research indicated a positive link between the existence of audit committees and quality of financial reporting proven by an analysis indicating earnings overstatement are less likely at companies with audit committees (DeFond & Jiambalvo, 1991:644) and companies

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<sup>53</sup> DeFond and Jiambalvo (1991:644); Beasley (1996:463); Dechow et al. (1996:1); McMullen (1996:87).

<sup>54</sup> Abbott et al. (2000:55); Beasley et al. (2000:441).

manipulating earnings are less likely to have audit committees (Dechow et al., 1996:1). Other criteria of financial reporting quality<sup>55</sup> were also used to measure irregularities in financial statements and the link with audit committees showing a reduced incidence of errors and irregularities (McMullen, 1996:87). Initially, Beasley (1996:459) found that audit committees do not significantly affect the likelihood of fraud but in a later study found firms where fraud occurs have fewer audit committees, less independent audit committees, fewer audit committee meetings, and less internal audit support than firms where fraud does not occur (Beasley et al., 2000:441). Another study showed audit committees that are both independent and active are associated with a decreased likelihood of fraudulent or misleading reporting earnings (Abbott et al., 2000:55).

In her study on the relationship between audit committee characteristics and the quality of financial reporting, Giles (1998:4) describes the role of the audit committee to oversee factors that impact on the financial reporting process and the quality of financial information. Factors include the system of internal control, scope of external audit, independence of external audit and appropriateness of accounting standards, and reasonableness of estimates used in preparing the financial statements. She researched whether combined professional characteristics such as education, professional certification, number of directorships held, current job status, and independence factors impact on the quality of financial reporting. Her findings suggest that firms with higher quality financial reporting have audit committees with more experienced members either as serving chief executive officer or as a board member elsewhere (Giles, 1998: ii).

Turley and Zaman (2004:320) responded to earlier research, indicating that these studies do not prove that improvement in financial reporting quality is specifically due to the existence of audit committees or specific audit committee characteristics but rather that reporting outcomes are the result of other corporate variables. Turley and Zaman (2004:321) conclude by stating that although there are mixed findings of the variables representing audit committee characteristics and financial reporting quality, both audit committee meetings that measure audit committee activity and independence of audit committee members have consistently been found to be associated with better quality financial reporting.

At the same time, Cohen et al. (2004:88) also completed a detailed study on corporate governance and financial reporting quality to research the interaction between actors and

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<sup>55</sup> Criteria include shareholder litigation alleging fraudulent financial reporting; correction of quarterly reported earnings; SEC enforcement actions; illegal acts and auditor turnover because of the client and auditor disagreement (McMullen, 1996:87).

institutions that affect corporate governance. Cohen et al. (2004:88) found that prior research focussed mostly on the board and audit committees and suggest a more comprehensive framework should consider all major stakeholders including inside (management and internal audit) and outside (legal system, regulators, financial analysts, legislators, external audit, and the AC) the firm. They also found prior research focussed on documenting associations rather than causal relationships and identified the need to investigate the substance of interactions in the corporate governance arena. Relating to prior research on boards and audit committees, their synthesis states that the effectiveness of the audit committees not only depends on the knowledge and expertise in financial reporting but also the extent of support by the board. Relating to financial reporting, the synthesis of prior studies by Cohen et al. (2004:88) further showed the critical role audit committees play in resolving auditor-management disagreements on significant financial reporting issues. The researchers recognise the need for audit committees to be provided with real power by the board to enable effective monitoring of management actions. According to Cohen et al. (2004:102), the audit committee and the auditors should be allies in the goal of achieving high-quality financial reporting and prevention of fraud. This study included a more comprehensive framework, suggested by Cohen et al. (2004), by including the different stakeholders and the interactions between them and the AC. The various determinants are discussed in Chapter 5 and the results of the fieldwork in Chapter 7. As part of this research, the perception on the knowledge and expertise of audit committee members in financial reporting and the support provided by the governing body and other stakeholders are determined and the results reflected in Chapter 7.

In later research, Bédard and Gendron (2010:175) studied the literature on audit committees to evaluate the extent to which audit committees are effective in strengthening financial reporting. They investigated measures of effectiveness including financial reporting quality from a perceptual perspective by reporting from the viewpoint of the different actors involved. (Their analysis showed for financial reporting quality, measured for example fewer misstatements, less earnings management and higher voluntary disclosure of information, 69% of the actors indicated a positive association between the adoption of an audit committee and effective financial reporting (Bédard & Gendron, 2010:175-185).

In the South African context, Marx (2008:316) shares the view of the important role that audit committees play in the quality of financial reporting and states the following:

“The audit committee has a very important responsibility for assessing the fair presentation of the financial statements. This is only possible, however, if the audit committee is effectively constituted, comprising members who are independent and have the required level of financial



literacy, experience, and expertise to perform their responsibilities with insight, vigour, and alertness.”

The research described above includes the relationship between the audit committee and financial information quality. However, it is also important to analyse the specific activities prescribed or recommended for the audit committee including oversight of financial accounting policies, financial reporting environment, and financial statements. Wolnizer (1995:47) identifies the responsibilities under accounting and financial reporting to include reviewing the financial statements for credibility before the release, reviewing the accounting policies, reviewing the effectiveness of internal control, evaluating the exposure to fraud, reviewing significant transactions including non-routine type, and appraising key management estimates. The Treadway Commission requires the audit committee to inquire about the existence and substance of significant accounting accruals, reserves, or estimates made by management that have a material impact on the financial statements (National Commission on Fraudulent Financial Reporting 1987:185). Turley and Zaman (2004:309) state that audit committees are expected to monitor the reliability of the company's accounting processes and compliance with standards and the maintenance of preventative fraud controls. The IIA (2014:10) describe one of the key activities of the audit committee to review and advise on key financial management and performance reports. The audit committee should further review the financial statements with the external auditors and management and discuss any significant estimates and adjustments and difficulties or disputes that arose during the audit.

In South Africa, Marx (2008:82) describes the activities of the audit committee related to financial reporting to include:

“Financial reporting is complex and poses many problems, risks, and challenges to entities. The audit committee is tasked with the responsibility for oversight of the financial reporting process and as such should ensure that accounting policies are sound and that the financial statements are appropriately prepared and audited. Accordingly, it is critical that the audit committee should consist of independent directors with the right experience and expertise. Given the complexity of today's financial statements, it is essential that all the audit committee members should be financially literate and that at least one member should be a financial expert.”

In his study on the perceived effectiveness of audit committees in national government including over financial reporting and compliance, Van der Nest (2006:204) reported a perceived effectiveness rating of 69% by respondents. Elements assessed in the area of financial reporting included the audit committee processes to obtain information related to

financial reporting issues, unusual transactions, and performance against the budget, and obtaining an understanding of critical accounting principles.

King IV recommends that the audit committee provide independent oversight of the integrity of the annual financial statements and, if delegated by the governing body, other external reports issued by the organisation (IODSA, 2016:55). One such document could be the integrated report or, in the context of municipalities, the annual report. King IV also allows for the governing body to delegate the approval of the financial statements, although the governing body remains ultimately accountable for the delegated responsibilities (IODSA, 2016:55). This is also allowed in terms of section 160 (2) of the Constitution (RSA, 1996), which only prohibits the delegation by the Council of passing by-laws, approval of budgets, imposition of rates and other taxes, levies and duties and the raising of loans (RSA, 1996).

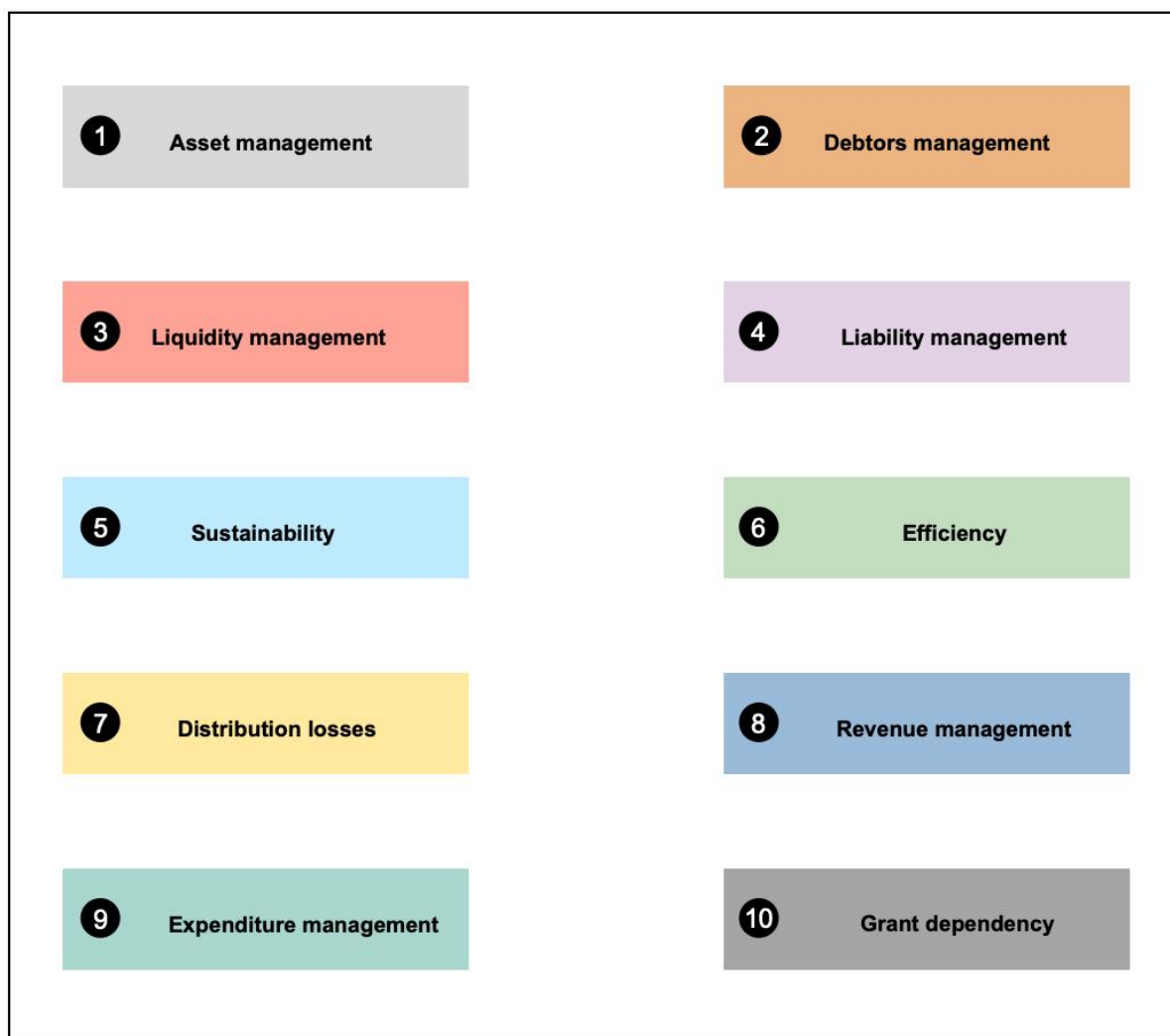
Within the local government sphere, section 166 (5) of the MFMA (56 of 2003) (RSA, 2003) describes the role of the audit committee to include advising the municipal council, political office-bearers, accounting officer, and the management of the municipality or municipal entity on, *inter alia*, the adequacy, reliability, and accuracy of financial reporting and information. Delegation of the approval of the annual financial statements to the audit committee at municipalities will not be an option due to the legislative advisory role of the AC. However, as indicated during the fieldwork the audit committees play a very important and valuable role in the review of the annual financial statements before submission to the Auditor-General.

The MFMA, (56 of 2003) (RSA, 2003) in section 52, describes the general responsibilities of the mayor to provide general political guidance over the financial affairs of the municipality. As part of providing such guidance the mayor may monitor the accounting officer and CFO in the fulfilment of their responsibilities but may not interfere in the execution thereof. The mayor also needs to take reasonable steps to ensure the municipality performs its functions within the limits of the approved budget. The mayor must further submit a quarterly report to Council on the implementation of the budget and financial state of affairs of the municipality. Section 71 of the MFMA requires the accounting officer to submit to the mayor and provincial treasury a monthly report (also referred to as Section 71 report) on the state of the budget for that month and financial year up to the end of that month including actual versus budget performance including explanation of variances and corrective actions. Section 72 (also referred to as Section 72 report) of the said Act further requires the accounting officer to submit a mid-year budget and performance assessment report to the mayor, provincial, and national treasury (RSA, 2003). As indicated in this section, audit committees in municipalities have a very specific role to play in the review of financial statements but to a lesser extent on budgets and



budget information. As part of its advisory and monitoring role, the audit committee will need to scrutinise and interrogate the section 72 reports during its meeting with the accounting officer and management and report to council any matters that should be brought under their attention. At one of the rural municipalities, a representative of council indicated that inputs into the budgeting information to be an area where the council would like the audit committee to become more involved with from an advisory point of view: In response to my question on where the audit committee can add more value she reacted to me by stating ‘ ... *the budget. If they can provide more advice especially on for example buildings and what we should be budgeting and indicating if it might be a fruitless expenditure or advice on alternatives. ... it will be particularly nice in terms of the budget to give us advice that we can plan ahead and then you do not get the situation where you have 300 homes that need to get taps and there is no budget for it.*’ As indicated in Chapter 7, several participants also expressed the wish for the audit committee to become more involved from a financial management point of view and not merely review the financial statements before submission for external audit.

To assist audit committees, the Public Sector Audit Committee Forum issued a discussion document on the role of the audit committee in financial analysis of municipalities (IODSA, 2018). The document covers two areas of the AC’s role in financial analysis being the financial strategy focus and the interpretive analysis of financial ratios. The strategic focus areas include the budgeting process, pricing of services, working capital management, funding, investment strategy, employees, supply chain management, audit findings, reporting systems, and infrastructure maintenance. For each of the strategic focus areas, the discussion paper provides guidance on the activities the audit committee should conduct related to the focus area. The role of the audit committee should be to strategically advise municipal management to ensure sufficient funds are available to meet the needs of the community and the mandate of the municipality (IODSA, 2018:3-6). The second area of the AC’s role in financial analysis refers to the monitoring of the financial ratio’s, financial analysis, and reporting. The discussion document contains the purpose of each ratio, the ratio norm that will guide the audit committee in the analysis of the financial performance, the formula, data sources, and how the ratio should be interpreted (IODSA, 2018:6-11). Figure 4.3 highlights the focus areas of the ratios.



**Figure 4.3. Focus areas for ratio analysis recommended by the PSACF (IODSA, 2018:7).**

One of the examples from an extract of an audit committee charter related to the financial reporting environment at one of the cases stated the following:

The Municipality's annual financial statements should be reviewed by the [audit committee] at least two weeks before submission to the Auditor-General. The process and timelines for the [audit committee] meetings should be changed accordingly.

The [audit committee] must review the annual financial statements to provide the ... Municipality with an authoritative and credible view of the financial position of the municipality.

Specifically, with regards to Annual Financial Statements, the [audit committee] should:

4.3.1 Review and challenge where necessary –

4.3.1.1 arithmetical accuracy and consistency.

4.3.1.2 consistency of, and any changes to, accounting policies, comparing to prior years.

4.3.1.3 methods used to account for significant or unusual transactions where different approaches are possible.

4.3.1.4 whether the Municipality has followed appropriate accounting standards and made appropriate estimates and judgments, considering previous audit outcomes.

4.3.1.5 the quality of disclosure in the Municipality's financial reports and the context in which statements are made.

4.3.1.6 all material information presented within the financial statements, such as the operating and financial review and the corporate governance statement (insofar as it relates to the audit and risk management).

4.3.1.7 all material issues in prior reports by the Auditor-General have been appropriately accounted for, resulting in fair presentation; and

4.3.1.8 conduct analysis of trends and other financial ratio calculations e.g. year on year comparisons and composition of primary group such as salaries as a component of operations, whether operations are undertaken on a sustainable basis, operations at surplus or deficit, efficient and solvency ratios, etc.

To adequately meet their responsibilities, the data and information provided to audit committees should be timely, accurate and complete. The audit committee should also be aware of the key challenges the municipality faces and have access to financial and performance information (refer to section 4.13 on performance management) and other reports to perform an analysis and ask the right questions.

Various sources of information and support can be used by the audit committee to assist in fulfilling the responsibilities of oversight over adequacy, reliability, and accuracy of financial reporting and information. One such source is the Section 52 report issued by the mayor to the council every quarter. Section 52 of the MFMA (56 of 2003) (RSA, 2003) requires the mayor to submit a report to Council on the implementation of the budget and the financial state of affairs of the municipality within 30 days of the end of each quarter. As part of the oversight and advice, the section 52 quarterly reports need to be studied and interrogated by the audit committee and discussed with management and, where necessary, the council.

The finance section within a municipality plays a key role in providing financial information to the AC. Jensen and Payne (2003:102) recognise that the recruitment of accounting personnel with high levels of accounting expertise can improve the quality of accounting information. These experts can capture information to assist with decision-making and are better equipped to understand complex accounting issues. This has become an extremely important issue in South African local government where the continuous issue of complex Generally Recognised

Accounting Practices (GRAP) have proven difficult for municipalities to implement, especially in rural municipalities that do not always have access to financial expertise. This has also resulted in municipalities relying on the audit committees to provide more assistance in this regard. The snowball effect is the need for more expertise on audit committees, the access to which is a prevalent challenge identified by most of the participants in this study and further discussed in Chapter 7. Further complicating the matter is the difference in interpretation of some of the GRAP standards between the Auditor-General and management at municipalities requiring more audit committee members to become involved in facilitating the disagreements and discussions between management and the auditors.

Section 59 of King IV requires the audit committee to disclose the AC's view on the effectiveness of the CFO and the finance function (IODSA, 2016:56). Certain financial competency level requirements for the accounting officer (MM), senior managers, CFO, other financial officials, and supply chain management officials' levels are also prescribed in the National Treasury: Local Government: MFMA: Municipal Regulations on Minimum Competency Levels (National Treasury, 2007). As part of the assessment of MFMA compliance, the audit committee also needs to ensure adherence to the minimum competency levels of the finance function. The PSACF has issued guidance in this assessment of the finance function in the discussion document, Public Sector Audit Committee: Assessment of Finance Function (IODSA, 2014b). The discussion document includes an assessment questionnaire which the audit committee can use as a guideline to assess the finance function (IODSA, 2014b:4-5). The extent to which audit committees disclose their view on the effectiveness of the finance function, as required in King IV, were also assessed as part of the fieldwork, and are presented in Chapter 7.

Other sources the audit committee can use to assist with fulfilling their responsibilities of oversight and advice over adequacy, reliability, and accuracy of financial reporting and information include internal audit and external audit. The audit committee needs to review the work performed by the IAF and external audit on financial information, note their findings, and ensure corrective actions are taken where required. The role and responsibilities of the audit committee in relation to internal and external audit are discussed in sections 4.8 and 4.11, respectively.

### My story

I agree with the view that traditionally and currently one of the most important roles and responsibilities of the audit committee is the review of the financial statements, including oversight of the financial accounting policies and financial reporting. Challenges in this regard were experienced specifically during the past two years with the increased emphasis on compliance to complicated GRAP and the implementation of a new Municipal Standard Chart of Accounts (MSCOA) and in my opinion sometimes unreasonable expectations by governance parties of the role the audit committee play in this area. Furthermore, if one looks at the timelines between the issue of the draft financial statements and submission to the Auditor-General for audit purposes, I cannot help to think of the research question by DeZoort et al. posed in 2002 that remains unanswered:

Can the audit committee ever hope to meet the expectations placed on it by various stakeholders and actually achieve ACE [audit committee effectiveness] given its current structure (e.g., part-time limited resources)? (2002:65).

At some of the municipalities where I serve on as an audit committee member, due to challenges with MSCOA and different GRAP interpretations, the audit committee had three working days to work through the draft financial statements. Despite a detailed analysis by the audit committee members and detailed advisory commentary by the financial expert on the audit committee there was still a finding by external audit that the audit committee, despite reviewing the financial statements, only provided some assurance, but did not adequately address all material deficiencies in control as material misstatements existed in the submitted Annual Financial Statements. If one refers to the challenges experienced and referred to in section 7.4.7, especially related to the availability and willingness of audit committee members in local government, this is an area that needs to be further researched and addressed. It must be remembered that the role of the audit committee is advisory.

The activities of the audit committee relating to financial analysis of municipalities required by legislation and recommended by the various guidelines are very comprehensive and this study has not attempted to research and analyse the extent to which the detailed requirements are implemented. However, the stakeholder's perceptions of the importance of the role of the audit

committee in the accounting policy and financial reporting environment and fulfilling that role formed part of this research and is discussed in Chapter 7.

The next three sections, which are closely interlinked, discuss information on other high priority responsibilities of the audit committee as reflected in traditional and current literature, namely overseeing the IAF, the role of the audit committee in driving internal control, and risk management.

#### 4.8 Overseeing the IAF

Research on the association and interaction between the audit committee and internal audit covers a variety of issues. In 1997, DeZoort surveyed audit committee members, and their responses indicate that they considered the review of internal audit as a very important oversight area (DeZoort, 1997:224). Later studies indicate that corporate governance codes in many countries place substantial emphasis on the oversight of the internal audit process by the audit committee (Zaman & Sarens, 2013:496). This section explores the role of the IAF including the CAE, the role of audit committees related to the IAF, the relationship between the IAF and the AC, the benefits derived from this relationship and factors influencing it, and challenges faced by audit committees and the IAF.

The relationships between the IAF and the audit committee and the positive impact thereof on corporate governance have been demonstrated in research. Research undertaken in the early 1990s identified that a close and effective working relationship between the audit committee and the IAF will be beneficial not only to the organisation that they serve, but also to society as a whole (Rezaee & Lander, 1993:40). Scarbrough et al. (1998:53) find the goals of audit committees and internal audit are strongly related and the ability of the audit committee and internal audit to work together can significantly impact the effectiveness of audit committees. Bishop, Hermanson, Lapides, and Rittenberg (2000:51) argue that increased interaction between the audit committee and internal audit result in improved quality of corporate governance. The mutual strengthening of the functions of internal audit and the audit committee as a result of the relationship has also been recognised by Goodwin and Yeo (2001:107). Cohen et al. (2004) also acknowledge a close relationship between internal auditors and the audit committee has the potential to improve the corporate governance experiences of both parties. The independence of internal audit is enhanced when it reports directly to the audit committee and the perceived value of internal audit is greater when it is used as an important part of the AC. The effectiveness of the audit committee is also

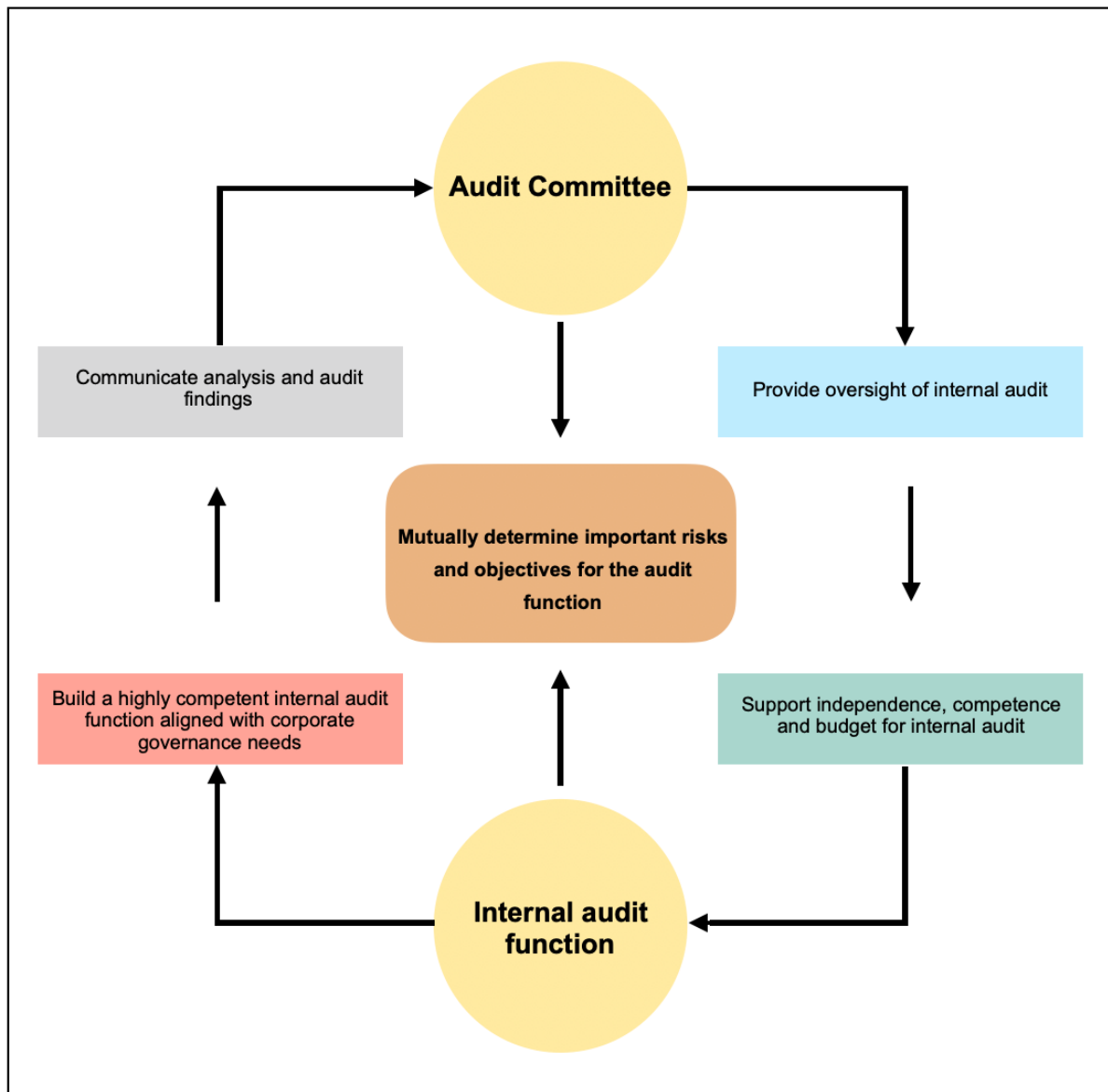
strengthened when it can use the resources of internal audit as a source of information on areas such as internal control and the quality of accounting policies (Cohen et al., 2004:125). This 'reciprocal' benefit is also recognised by Turley and Zaman (2004:309) where audit committees can be seen to support the audit function, while internal audit can assist the audit committee to meet its responsibilities. The audit committee can also benefit from an effective internal audit through the assistance provided by internal audit, considering the limited time and oversight capacity of the audit committee (Braiotta, 2004:249-250). Gramling et al. (2004:198) state that professional governance guidance, standards, and best practice highlight the importance of a high-quality relationship between the audit committee and the internal audit function. In the document on internal audit oversight, the IIA states that according to best practice the audit committee should define in its charter the scope of its relationship with the internal auditors and should work to enhance its oversight responsibility to strengthen internal audit (IIA, n.d.:2).

In the discussion of the interaction between the audit committee and internal audit, Rittenberg uses the figure from the IIA Research Foundation depicted in Figure 4.4 to show the mutual relationship between the audit committee and internal audit.

The IAF plays a valuable supportive role in the relationship with the AC. DeZoort et al. (2002:59) refer to various studies that suggest the important supportive role internal audit plays to promote effective audit committees. Bishop et al. (2000:50-51) identify the areas where support by internal audit to the audit committee could be provided to include, *inter alia*, facilitating information flow, performing special investigations requested by the AC, assessing financial reporting quality, evaluating internal controls and the credibility of quarterly management reports, and monitoring of financial and business risks. Another important area in which the IAF must provide assurance to the audit committee is on risk management to ensure the key business risks within an organisation are adequately managed through a sound framework of internal controls (Motubatse, 2014:40).

On facilitating the information flow, examples of information the internal audit function can provide to the audit committee include information on potential lawsuits against the organisation, feed-back on the reliability of the management information system, compliance with ethical standards of the organisation, effectiveness of controls, the variances between capital budgets and actual costs, whether approved capital expenditures produced the results expected, and achievement of objectives and goals (Motubatse, 2014:41).





**Figure 4.4. The mutual relationship between the audit committee and the internal audit function** (Rittenberg, 2016:3).

Gendron et al. (2004:165) recognise that audit committee members rely on the work of internal audit to evaluate the effectiveness of internal controls and become comfortable with the effectiveness by assessing the extent to which internal audit recommendations are implemented. The IIA, in the document on internal audit oversight, also recognise internal auditors as important resources for the audit committee by reviewing the audit committee charter, providing timely information on new legislation and regulations, and fulfilling the role of educator (IIA, n.d.:2).

The role of the audit committee in relation to internal audit has also been considered by different researchers. The role of the audit committee includes both monitoring and supporting.

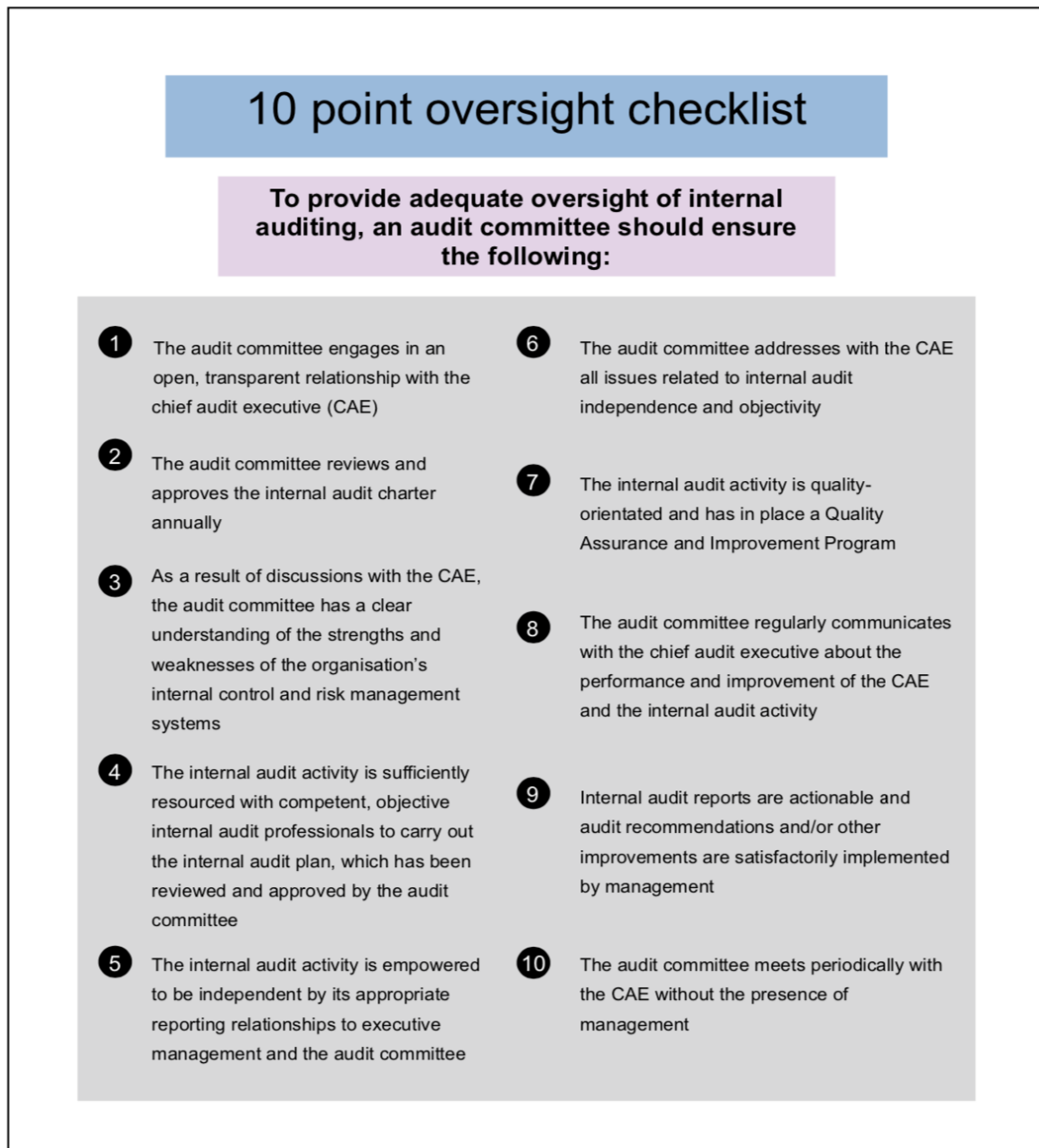
Kalbers (1992b:44) finds that internal auditors believe their effectiveness is positively influenced by the audit committee if the committee consists of knowledgeable members who actively and effectively carry out their duties and he urges audit committees to ensure sufficient time and attention is given to internal auditors' scope, budgets, and reports. In later research, Barua, Rama and Sharma (2010:511) examined the association between the characteristics of the audit committee and investment in the internal audit function. They found companies with long-tenure audit committees with an auditing expert member spent fewer resources on internal auditing, which indicates that firm-specific knowledge obtained by longer tenure may be a substitute for investment in internal auditing. They further found that investment in internal auditing is positively related to the number of audit committee meetings. This might suggest more diligent audit committees (measured by increased meetings) are more supportive of internal audit leading to a higher internal audit budget (Barua et al., 2010:511).

Regarding the monitoring role of the AC, the various commissions on governance all recognised the important role of the audit committee in ensuring the internal auditor is accountable to the AC. The Treadway Commission recommends that the AC, together with the chief internal auditor and the independent public accountant, review the annual audit plans to ensure proper co-ordination of the different plans (National Commission on Fraudulent Financial Reporting, 1987:183). According to the Cadbury Commission, the audit committee should review the internal audit program, ensure co-ordination between the internal and external auditors, and ensure the internal audit function is adequately resourced (Cadbury Commission, 1992:72). The BRC states that the audit committee must endorse the processes and safeguards employed by the internal auditors (BRC, 1999:1090).

In their national survey on audit committees in local government in the USA, West and Berman (2003:344) identify the activities of audit committees relating to internal audit to include being informed about internal control weaknesses and significant audit adjustments, reviewing internal audit program and results of internal audit work on financial reporting, internal control, and operational audits, and meeting privately with the CAE. Braiotta (2004:282-283), in the Audit Committee Handbook, indicates these vital checkpoints for the audit committee in the monitoring of internal audit and concludes with the following seven salient points as guidance to audit committees: 1) Assist in the development and approve internal audit policies to ensure internal staff has the necessary authority; 2) review the scope of internal and external audit plans for optimum resource allocation; 3) review internal and external audit reports, evaluate the content, and the implementation of recommendations; 4) review and assess internal staff's organisation including auditing philosophy, independence, and logistical operations; 5) assess the quality of auditing personnel and training to ensure adequately staffed and quality control

processes provided for; 6) provide assurance to the chief internal auditor of the AC's support, provide open communication, and obtain assurance that internal audit staff is receiving proper cooperation from management; and 7) determine the need for special assignments (Braiotta, 2004:288-289).

The IIA, in the document on internal audit oversight, presents a 10-point oversight checklist reflected in Figure 4.5 below:



**Figure 4.5. 10-point internal audit oversight checklist (IIA, n.d.:3).**

According to the research by Gendron et al (2004:166) audit committees consider the competence and independence of the internal audit as the audit committee is dependent on the quality of the work performed by the IAF to be able to fulfil their own responsibilities (2004:166). Davies (2009:41) identifies the roles to include assessing the performance of the internal audit function, appointing the CAE and support and promote the audit function within the organisation. The audit committee is also required to review the internal audit reports material to the organisation and management's response to the reports (Davies, 2009:38). Abbott, Parker and Peters (2010:1) researched the association between audit committee characteristics and internal audit and measured the control by audit committees over the internal audit by examining reporting duties, termination rights, and budgetary control. The results showed that where audit committees have a greater oversight role over internal audit, in comparison with management, the allocated proportion of the internal audit hours in the area of internal control is larger.

The importance of the role of the audit committee in the selection process of internal audit is highlighted in Braiotta's (2004) book on audit committees. He argues that the audit committee needs to review the knowledge, skills, and other competencies collectively needed by internal audit to enable it to perform its responsibilities. The quality and training have an important influence on their performance and, if there is misalignment between responsibilities and training, skills, and education, it will result in routine checking making the institution more susceptible to internal control deficiencies and potential fraudulent practices. The audit committee should therefore review the selection process of internal audit staff and ensure the internal audit group has established policies and procedures for adequate staffing, levels of supervision, and continuing education programs (2004:276). In South African local government, based on experience, the role that the audit committee must play in relation to the appointment and dismissal of the chief internal audit is still under debate. Due to the legislation referring to an advisory role, some municipalities believe that appointment and dismissal are administrative rather than functional responsibilities and the audit committee should not be involved. This is contrary to academic and non-academic research in this area but demonstrates the importance of the legislative role given to audit committees.

Audit committees play an important role in strengthening the independence of internal audit. Through the functional reporting of internal audit to the AC, the organisational independence of internal audit is provided for. Turley and Zaman (2007:777) find that internal auditors normally report any concerns to the chief executive officer as a line manager, unless the issue relates to the line manager or other senior management at an equivalent or higher level than

the internal audit in the organisational hierarchy, in which case the matter is likely to be reported to the audit committee.

The audit committee activities relating to internal audit as described by the IIA includes review and approval of the internal audit charter and internal audit plan and monitor the internal audit performance against the plan. The audit committee should also review the internal audit reports and management action plans to address recommendations. The audit committee is also responsible to advise the governing body on the adequacy of resources and skills and abilities to execute the audit plan. The IIA also recommends that the audit committee should provide advice on the recruitment, appointment, retention, and removal of the CAE. Leading practice further suggests the audit committee should also be involved with the performance review and remuneration plan of the CAE (2014:9). Alzeban and Sawan (2015:61) found a strong correlation between independent audit committee members and the implementation of internal audit recommendations.

However, on performance assessments of internal audit, a recent document issued by the IIA reflects on the omission in the oversight by audit committees to provide appropriate feed-back to internal audit on their actual performance. The discussion document refers to typical feed-back that should be but is not provided, including 'You send us too much information'; 'We don't always get the full picture because you don't connect the dots'; 'We want you to focus on more than just financial controls, but we're not sure you have the skills', and 'We need you to bring us an independent view – not to be the 'mouthpiece' for management' (Committee Leadership Network, 2018:2-3). The need for a meaningful assessment of internal audit has also been identified by the Audit Committee Leadership Network (2018:7). The IIA's standard 1312 requires that the internal audit function be reviewed once every five years by a qualified, independent assessor or an external assessment team (IIA, 2016).

Sarens et al. (2009:91) studied the relationship between internal audit as a supporter of and comfort provider to the AC. They used four case studies and interviewed the heads of internal audit and ACC. The researchers found audit committees were uncomfortable in mainly two areas: the control environment and internal controls. However, the involvement of internal audit specifically in improving internal controls provided a significant level of comfort to the AC. The internal audit was able to provide a major source of comfort as a result of their unique knowledge about risk management and internal controls, the appropriate inter-personal and behavioural skills they possess, their intimate knowledge of the company, and their proximity to people across the company. The researchers further found symbols of such comfort included the formal internal audit reports and informal contacts with internal audit. The study

by Erasmus and Coetzee (2018:109) found the standing of the IAF within the institution and the role and services provided are considered to be the most important determinants of effective IAFs.

Support will also include promoting internal audit within the organisation (Davies, 2009:41). Through the support and guidance by the audit committee internal audit have a certain degree of influence in the organisation (Turley & Zaman, 2007:783). If the internal audit is strengthened by the AC, it can be a very important source for the audit committee in fulfilling its responsibilities (Beasley et al., 2009:102; Gendron & Bédard, 2006:223; Turley & Zaman, 2007:783).

Another area where the audit committee could provide support is in the improvement of internal audit reports to the audit committee and through active engagements (Audit Committee Leadership Network, 2018:8-9). A study by Mbewu and Barac (2017:23), revealed the need expressed by CAEs at municipalities to hold more frequent in-committee/private meetings with the audit committees.

Factors influencing the relationship have been identified by research to include audit committee composition, financial and technical experience and formal and informal interaction between the AC, and internal audit, personalities, and communication. A study by Raghunandan et al. (2001:105) examines the association between audit committee composition and the AC's interaction with internal auditing. The results show that if the composition of the audit committees comprise of solely independent non-executive directors with at least one member having either accounting or finance background, the audit committee was more likely to (1) have longer meetings with the CAE; (2) be provided private access to the CAE; and (3) be capable of reviewing internal audit recommendations and the results of internal audit activities (Raghunandan et al., 2001:105). Similar results were found in the study by Goodwin (2003:263-264) that examined the relationship between the internal audit function and the audit committee in Australia and New Zealand for both the public and private sectors but focussing on the separate influence of independence and financial experience of the audit committee on the relationship with internal audit. The argument is that members of the audit committee must understand the work of internal audit (technical expertise) and be independent to improve the status of internal audit (Goodwin, 2003:263-264). The researchers found that the independence of the audit committee and the level of accounting experience between the different audit committee members have a positive impact on the relations between the audit committee and internal audit. Independence is associated with several processes, for example, frequency and length of meetings with internal audit, privacy of the meetings, and involvement

in decisions to dismiss the chief internal auditor. The accounting or finance background is associated with the extent of the work of internal audit being reviewed by the audit committee (Goodwin, 2003:263-264).

Goodwin and Yeo (2001:122) confirm the need for the internal audit team to have private and regular access to their audit committees. Krishnan (2005:652) reported that high-quality audit committees tend to engage more with internal and external auditors about internal controls and the effectiveness thereof and follow up on the implementation of recommendations for improvement in internal controls by management. This was confirmed in the study by Singhvi, (2011:27) where she states that although the audit committee and internal audit have different responsibilities their goals of ensuring effective internal controls overlap and effective communication will lead to better monitoring by the audit committee.

Davies (2009:41-42)\_ identifies factors influencing the relationship to include the internal audit having confidence and respect for the audit committee and the ACC demonstrated by their skill and knowledge of the role of internal audit in financial and non-financial aspects in local government. In the South African context, internal audit has a critical role to play in non-financial and performance-related areas required by legislation (refer sections 4.8 and 4.13) and the audit committee needs to understand these requirements and be able to assess the performance of internal audit and advise as required. Davies (2009:60) concludes that the relationship between the audit committee and internal audit depends on individual personalities, governance processes, and the willingness to adhere to published guidelines for local government governance and audit committees. The respondents in the study by Davies (2009:60) also indicate the significance of the communication between the audit committee members and the head of internal audit, which is confirmed in the studies by Rezaee and Lander (1993:37). The importance of communication and creating avenues for open communication must be ensured by the audit committee (IIA, n.d.:5).

Zaman and Sarens (2013:495) studied the importance of informal processes in corporate governance by investigating factors associated with the existence and influences of informal interactions between audit committees and the internal audit function. The research provides empirical evidence on the influence of the AC, the ACC, the internal audit function, and the CAE characteristics on the informal interactions. Interactions between the audit committee and internal audit are very important to enable the audit committee to fulfil its oversight role (Zaman & Sarens, 2013:496). The research finds that regular informal interactions between the CAE and the audit committee takes place, which complements formal meetings. The informal interactions provide additional opportunities for the audit committee to monitor



internal audit functions. The research also determined that the knowledge and experience of the ACC in diverse areas<sup>56</sup> have a positive association with the existence of informal interactions between audit committees and the internal audit function. Another positive association is identified between the existence of informal interactions and the quality of the internal audit function (Zaman & Sarens, 2013:497). Other proponents of oversight through informal processes are Beasley et al. (2009:113), Gendron and Bédard (2006:230), Turley and Zaman (2007:782), and Zain and Subramaniam (2007:894).

Research related to the audit committee and internal audit confirms the importance of the relationship but highlights the challenges in practice. Scarbrough et al. (1998:61) identified possible challenges, which include the lack of involvement of audit committees in decisions about dismissing the chief internal auditor, lack of regular meetings with the CAE, allowing for private access to the CAE, and lack of the review of the internal audit programme and the results of internal auditing. Rittenberg (2016:1) still noted one of the challenges to be the low opportunity for the internal auditor to meet with the audit committee without management being present.

In South Africa, the King IV (2016:69) states:

The governing body should assume responsibility for internal audit by setting the direction ...to provide objective and relevant assurance that contributes to the effectiveness of governance, risk management and control processes. The governing body should delegate oversight of internal audit to the audit committee, if in place.

The Public Sector Audit Committee Forum has also issued three discussion papers related to internal audit for guidance to audit committees, including the Public Sector Audit committee role in overseeing internal audit (IODSA, 2014c), the role of audit committees in relation to external and internal audit process (IODSA, 2015b), and evaluation of the internal audit function (IODSA, 2015a). The guidance document on overseeing internal audit lists 22<sup>57</sup> areas of oversight and responsibility (IODSA, 2014c:4).

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<sup>56</sup> Areas include knowledge of business, business specific risks, corporate governance, risk management, internal control, accounting and finance, and internal and external auditing (Zaman & Sarens, 2013:500).

<sup>57</sup> Areas include: review and approve internal audit charter, review and ensure adherence to IIA standards, ensure IAF reports annually on quality assurance and improvement programme, assess options for sourcing internal audit, assess adequacy of skills and size of internal audit staffing, review three year training program for internal audit, ensure transfer of skills by contractors if applicable, assist in recruitment process, performance appraisal and compensation of CAE, approve the risk-based internal plan, review and approve the allocation of budget, encourage cooperation between internal and external audit, review and track quarterly progress against approved plan, review and approve reports from internal audit on a quarterly basis, ensure open line of communication with internal audit, monitor and evaluate effectiveness and quality assurance of the internal audit function, review policies affecting the functioning of internal audit, understand the format of reports being presented by internal audit, recommend the appointment of an external service provider if the internal audit function is outsourced, review

In South Africa, research on, *inter alia*, the relationship between internal audit and audit committees was covered in research by Van der Nest (2005) and Motubatse (2014). Van der Nest (2005:76) solicited the views of the CAEs in each of the South African national government departments to measure the extent to which audit committees in the national government departments comply with generally recognised functions including the effectiveness of the support from the audit committee to the internal audit function in the achievement of best practice auditing.

Van Der Nest (2005:76) acknowledges the close relationship between internal audit and the audit committee where the audit committee aids to ensure the internal audit is and remains independent and has the necessary resources and support to be effective. From the monitoring point of view, the audit committee needs to ensure quality internal audit work and compliance with the IIA standards (Van der Nest, 2005:80). Van Der Nest (2005:80) reported shortcomings in the line of communication between the CAE and the accounting officers and the CAEs indicating one of the contributing factors to be the lack of support by the audit committee to ensure the necessary budget and resources are allocated to the internal audit function. The research also indicates that although it is a requirement for the internal audit to comply with the IIA standards, only 58% of the audit committees evaluate the internal audit's compliance with these standards. The assessment of the risk management processes by the audit committees were also lacking in the view of the CAEs (Van der Nest, 2005:80-81).

Motubatse (2014:40) completed a case study at the National Treasury on customer perceptions of the internal audit function and identifies the need for the internal audit function to provide assurance to the audit committee on risk management (Motubatse 2014:40). Sarens and De Beelde (2006:2) also recognise the proactive role internal audit plays in risk management by focusing on high risk areas and making recommendations to improve internal controls.

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any reports from internal audit on limitation of scope, preside over disagreements between management and internal audit, strive towards setting a tone where internal audit feels confident to report any significant issues, review and assess the written assessment prepared by internal audit.

## My story

There is no doubt in my mind that one of the key relationships is between the audit committee and the CAE and the team. In research various terms have been used to describe this relationship – close, comforter, supporter, oversee, monitor, mentor - all of these are very apt descriptions.

Throughout my interaction with the IAF at various institutions, I have always experienced the IAF to support the audit committee, especially given the scope of the audit committee work and the time availability. The CAE makes your life easier by providing relevant information on time and highlighting important areas or areas of concern. Especially in highlighting weaknesses in controls, it assists the audit committee tremendously to fulfil its functions.

It is a relationship of mutual trust which is built by regular interaction, of which informal interactions and pre-meetings, without management present, provides the avenue to build on the relationship.

However, one of the dangers is that the relationship could become too close and as an audit committee member and ACC, I had to continuously remind myself about the importance of staying independent.

One of the questions, for example, as a result of the audit committee being very dependent on the IAF for information is: how honest would the performance evaluations of the CAE and IAF be in those cases where the audit committee is involved with the performance evaluations?

If one also looks at the different terms used to describe the relationship, it is almost impossible to imagine filling these different roles without some kind of paradox.

As a result of the audit committee and ACC playing a supportive role to the IAF in efforts to ensure the correct strategic positioning of the IAF, protecting the independence of the IAF and making sure the necessary attention is given to the findings of the IAF, I have also experienced that there is an almost unachievable expectation on what the audit committee and the ACC can do for the IAF.

The IAF plays a key role in municipalities. Similar to acquiring skilful audit committee members, municipalities struggle to acquire and retain competent internal auditors. Despite the important role of the IAF and the role of the audit committee to oversee and support, the lack of involvement of the ACC or audit committee members in the appointment and performance evaluations of the CAE remains challenging. I think the lack of involving the audit committee is closely related to the notion of not wanting the audit committee to interfere with management functions. However, I believe the audit committee can be part of the process (not run the process) to ensure the required knowledge, skills and competencies that are collectively needed in the IAF is obtained. As part of capacitating the IAF it is also very important to provide honest appropriate feed-back to the internal auditors.

Audit committees have an interest in the extent to which internal control is effective because it underlies the credibility of financial reports and ensures the control system covers the key risks of the organisation. Audit committees rely on the work of the internal audit to assist them in the assessment of the effectiveness of internal control. Internal control, risk management,

and internal audit are three important areas of corporate governance. In this section, the important roles and responsibilities and the relationship between the audit committee and internal audit has been discussed. The next section explores the audit committee as one of the drivers of internal control, followed by the review of risk management.

#### 4.9 Role as part of driving internal control

“Systems of internal control are vital to the internal administration of firms. They serve to safeguard the property of the firm, to establish levels of accountability and authority, to differentiate between areas of functional responsibility, to increase the likelihood that the policies and procedures prescribed by managers are implemented and followed, and to provide documentation of the commercial affairs of firms” (Wolnizer, 1995:57).

One of the critical functions of the audit committee is the oversight of internal control (Abbott et al., 2004:1; AICPA, 2016b; Chien, 2007:34; DeZoort, 1997:224; Goh, 2007:4; West & Berman, 2003:332). However, Turley and Zaman (2004:318) indicate the difficulty in researching this area is to find generalised signals of the internal control impact audit committees have. Within this section, the meaning and importance of internal controls are explained before the specific role of the audit committee related to internal controls and within local government is discussed.

The importance of effective internal controls to help ensure stakeholders are protected and the objectives of an organisation are achieved has long been recognised (Kinney, 2001:279; Kinney, Maher, & Wright, 1990:1; Stachowski 1994:12). Research has also shown that a weak control environment is positively related to incidences of fraud (Bell & Carcello, 2000:183).

Although internal controls have long been part of organisations, it received renewed emphasis with the enactment of the Sarbanes-Oxley Act (SOX), enacted by the USA Congress in 2002, (Goh, 2009:549), and again in 2013 when the Committee of Sponsoring Organizations of the Treadway Commission (COSO) published a document ‘Internal Control – Integrated Framework’ referred to as COSO 2013. The COSO document sets out a framework for internal controls and describes internal control as:

“... a process, effected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting and compliance” (COSO, 2013:3).

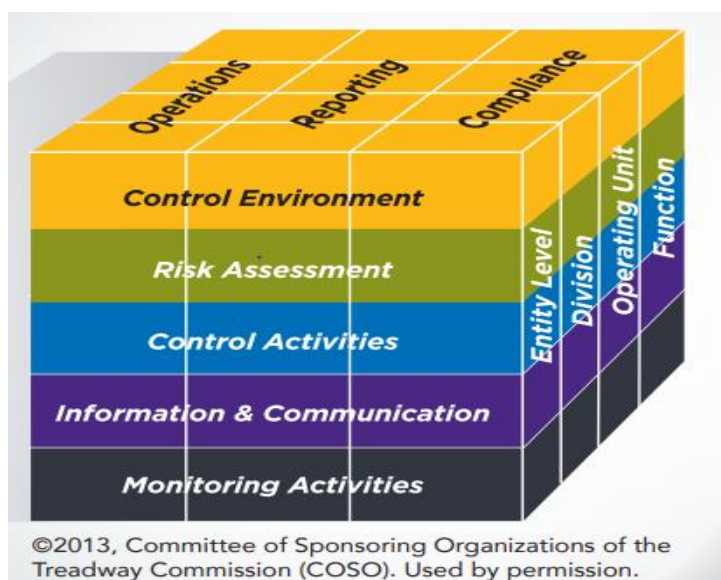
The term ‘internal controls’ has been described in many studies and by a variety of authors. Controls implemented within the organisation are referred to as internal controls and are defined in the International Standards of Auditing (Jackson & Stent, 2012:5/5) as:

“... the process designed, implemented, and maintained by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity’s objectives regarding:

- the reliability of an entity’s financial reporting;
- the effectiveness and efficiency of its operations, and
- its compliance with applicable laws and regulations.”

An effective internal control system provides reasonable assurance that policies, processes, tasks, behaviours and other aspects of an organisation, taken together, facilitate its effective and efficient operation, help to ensure the quality of internal and external reporting, and help to ensure compliance with applicable laws and regulations (KPMG, 2016a:1).

The five integrated components of internal control consist of the control environment, risk assessment, control activities, information and communication, and monitoring activities<sup>58</sup> (COSO, 2013:4-5). The relationship between objectives, the five components of internal control, and the organisational structure is reflected in Figure 4.6.



**Figure 4.6. Relationship of objectives and components (COSO, 2013:6).**

<sup>58</sup> The control environment refers to the set of standards, processes, and structures that provide the basis for carrying out internal control. Risk assessment involves dynamic processes for identifying and assessing the risk that can impact on achievement of objectives. Control activities are actions that ensures risk mitigating activities are carried out. Information and communication include providing, sharing, and obtaining information necessary to carry out internal control responsibilities. Monitoring include evaluations to ensure the five components of control exist and are working (COSO, 2013: 4-5).



From the different descriptions of internal control, various parties have a role to play in the implementation of effective internal controls. The different levels are further described in section 4.12 on combined assurance.

The Auditor-General in the 2015 consolidated general report on the audit outcomes of local government identified three drivers of internal control namely leadership, financial and performance management, and governance (AGSA, 2015:89). In the context of municipalities, leadership includes the legislature (council) that is supported by various role-players including the executive and administration that need to implement controls to ensure decisions and power are only used for the well-being of the community.

The MM at MUN6 confirmed the importance of the community, stating:

We need to be able to speak to each other openly and make sure, at the end of the day for me working for the community and if it's anything that can contribute towards service delivery, for me we need to use that and to use it proactively.

The role of the audit committee in relation to internal controls have been recognised in various corporate governance reports. The Treadway Commission requires the audit committee to exercise vigilant and informed oversight of internal controls (National Commission on Fraudulent Financial Reporting, 1987:41). The Cadbury Commission requires the audit committee to review the company's statement on the effectiveness of the control system before endorsement by the Board (Cadbury Commission, 1992: s431, s435 (e)(v)). The BRC requires the audit committee to ensure management develops and adheres to a sound system of internal control and assess management's internal controls (BRC, 1999:1084, 1090). According to the Turnbull Report's guidance, audit committees are expected to receive and review internal control reports. The audit committee should consider the significant risks, assess the effectiveness of the related controls, consider whether the necessary actions are being taken, and consider whether the findings indicate the need for additional and more extensive monitoring (Zaman, 2001:5).

From the AC's own perception, internal control evaluation is also considered important. In the surveys completed by audit committee members, they ranked internal control evaluation as the most important oversight area (DeZoort, 1997:224). In their research on the association between disclosures in the audit committee charters and reports, Carcello, Hermanson, and Neal (2002:294-295) found that audit committees recognise the importance of the review of internal controls and are active in reviewing internal controls. Ninety nine percent (99%) of a

sample of 150 audit committees included it as part of the audit committee charter (Carcello et al., 2002:294-295).

Through the study of the audit committee charters, this research confirmed the important role of reviewing internal controls. In all the audit committee charters, except one, the responsibilities of the audit committee related to internal controls were addressed under a separate heading. For the one exception it was included as part of internal audit.

DeZoort (1998:1) found that audit committees with financial experience, in contrast to committee members without, made internal control judgements more like auditors, suggesting that relevant expertise can make a difference in the oversight of internal control and risk management.

Two studies on the link between internal control quality and audit committees were completed by Krishnan (2005) and Zhang, Zhou, and Zhou (2007). In her study, Krishnan (2005: 649) finds that independent audit committees and committees with financial experts are significantly less likely to be associated with the incidence of internal control problems. Zhang et al., (2007:300) found that if audit committees have less financial expertise, the firms are more likely to have internal control weaknesses. Similar results are reported by Krishnan and Visvanathan (2007:73), who found that companies with internal control weaknesses were less likely to have financial expertise in the AC. They also found that regular audit committee meetings contributed to timely reporting of internal control weaknesses.

Goh (2009:550) investigated whether there is any link between audit committee characteristics and timeous correction of material weaknesses in internal control. The results suggest that firms with larger audit committees and a greater proportion of non-accounting financial expertise<sup>59</sup> on the audit committee tend to take corrective action for material internal control weaknesses timeously and rapidly.

Bédard and Gendron (2010:183-184), in their literature review on audit committees' effectiveness, also acknowledge one of the primary functions of the audit committee to be internal control oversight. They found that limited studies focussed on internal control quality and the studies that examined activities of the audit committee in relation to internal control and the quality thereof used the absence of internal control problems and illegal acts as

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<sup>59</sup> This is explained by Goh as expertise gained through experience supervising employees with financial reporting responsibilities versus accounting financial expertise referring to expertise gained through accounting-related experience (2009:550).



proxies, analysis on voluntary disclosure of internal control reports, and the audit committee members' judgment about the strength of the internal control systems. In this study, the extent of internal control problems was examined by referring to the Auditor-General reports, the annual reports of the municipalities were examined for voluntary disclosure on internal control, and the audit committee reports on the status of internal control. The results are discussed in Chapter 7.

Nashwa (2005:43) describes the following audit committee activities related to internal control: understanding the internal control objectives, considering whether the control environment and procedures will enable the achievement of the objectives, reviewing auditor's reports on internal controls and compliance with laws and regulations, determining whether material weaknesses were reported, and reviewing implementation of corrective measures related to internal controls.

The IIA requires of the audit committee to review and provide oversight on the internal control framework and keep abreast of significant matters identified by other governance, risk, and control assurance providers (IIA, 2014:9).

The Auditor-General, in the 2015 consolidated general report on the audit outcomes of local government, describes the key responsibility of the audit committee related to internal controls, namely, to promote accountability and service delivery by evaluating and monitoring how the municipality respond to risk. Furthermore, they should oversee the effectiveness of the internal control environment, the effectiveness of financial and performance reporting, and compliance with legislation (Auditor-General, 2015:89). Municipal managers, senior managers, and municipal officials are responsible to design and implement effective internal control systems. One of the root causes for poor audit outcomes identified is the slow response by management, political leadership, and oversight about addressing weaknesses in internal control (Auditor-General, 2015:95). The Auditor-General recommends that the accounting officers should view internal audit units, audit committees, and risk management functions. The Auditor-General also recognises the important role it plays and urge accounting officers to pay attention to the reports of these different assurance providers and regularly interact with them. Furthermore, management should develop action plans to address internal control deficiencies and mayors and council should hold the accounting officers responsible for control weaknesses. In their role, audit committees should assist council in their monitoring role by reviewing the implementation of corrective actions (Auditor-General, 2015:95).

Van der Nest (2006), in his study on the effectiveness of audit committees at national departments in South Africa, reported the perceived effectiveness of oversight of internal control at 76%. The following criteria were used: audit committee received enough information to review and understand the system of internal controls (74%); the audit committee enquires regarding the experience and sufficiency of staff in the internal audit and finance departments (63%); the AC's review of the annual internal audit plan (90%); audit committee review of management letters from internal and external audit to address significant issues (81%); AC's review of management responses (77%); AC's assessment of compliance effectiveness and other consulting services of internal audit (69%) and AC's evaluation of compliance with IIA standards (63%).

For local government in South Africa, section 166 of the MFMA specifically requires the audit committee to advise on internal financial control (National Treasury, 2012:2). The different corporate governance codes issued in South Africa also recognise the important role the audit committee plays in internal control. Principle 15 of King IV requires that the governing body should ensure that assurance services and functions enable an effective control environment and that it supports the integrity of information for internal- decision-making and of the organisation's external reports. The King IV makes provision for the governing body to delegate the responsibility for oversight to the audit committee to ensure the objectives of enabling an effective control environment and supporting the integrity of information and reports (IODSA, 2016:68). It further recommends that the CAE should have access to the chair of the audit committee and should report to the chair of the audit committee on the performance, duties, and functions of internal audit (IODSA, 2016:68-70).

Circular 65, issued by National Treasury to guide audit committees recognise internal control as a crucial component of sound corporate governance and describe the responsibilities of the audit committee related to the control environment, includes ensuring management follows a sound process to draw conclusions on the effectiveness of the system of internal control, establishing whether relevant, adequate, and effective policies and procedures are in place, determining if appropriate processes are implemented, and assessing steps taken by management to encourage ethical and lawful behaviour (National Treasury, 2012:13).

The importance of and link between internal control and risk management is demonstrated in the following quote:

"A company's system of internal control has a key role in the management of risks that are significant to the fulfilment of the business objectives. A sound system of internal control

contributes to safeguarding the shareholder's investment and the company's assets" (Financial Reporting Council, 2005:3).

This section described the responsibilities of the audit committee related to internal control and the following section explores the responsibility of the audit committee with reference to risk management.



#### 4.10 Audit committees' risk management responsibilities

Although the audit committees' roles and responsibilities in risk management and internal control are discussed in separate sections of this study, it cannot be read in isolation due to

the critical link between these two governance areas. One of the mechanisms for managing risk is internal control (IODSA, 2002:73). Although there are numerous professional articles about audit committees and their role in the areas of risk management and internal control, according to Turley and Zaman (2004:317), limited academic literature on the impact of audit committees on these two areas exist. Later research by Brennan and Kirwan (2015:477) confirms that limited information is available on the role of the audit committee in overseeing risk management or the extent to which audit committees are used to support the governing body with their responsibilities on risk management.

This section presents professional literature and research completed on the audit committee and risk management, followed by the specific requirements for audit committees in the local government context.

Crawford et al. (2008:212), in their study on audit committee effectiveness in Scotland, found the audit committee were not effective in the monitoring of organisational risk management and most audit committees limited the review to financial risks rather than organisational risks, including non-financial performance management issues. In the South African local government context, it is a legislative requirement for the performance audit committee to specifically review performance management, which includes both financial and non-financial information, and report on that to Council twice a year (refer to section 4.13). The extent to which audit committees are perceived to be effective in this regard is discussed in Chapter 7.

The IIA (2014:9) describes the role of the audit committee related to risk management to review and provide oversight on the establishment, implementation, maintenance, and effectiveness of risk assessment, risk management, and reporting thereon. A study by Thornton (2015:11) indicated CAEs and audit committees considered the focus on risk management as a top priority. KPMG (2016b:1) states that organisations have become much more risk-conscious and their management and oversight more risk-driven with the result that AC's time commitment for risk oversight has increased substantially over the last few years.

Cohen et al. (2017:1178), to some extent, responded to the gap in the academic literature and examined the experiences of audit partners, CFOs, and audit committee members on the association between enterprise risk management and the financial reporting process. The results of the examination showed all three types of participants viewed enterprise risk management as having a direct link to the quality of the financial reporting process and the strength of internal controls. On the other hand, it was found enterprise risk management has little impact on the quality of audit services. It was also found participants limit their role to risk

assessment/identification practices with less emphasis on strategic issues coming from the enterprise risk management process. The insufficient emphasis by audit committee members and the CFOs are questioned and identified as an opportunity for these participants to become more involved where audit committee members can bring a more strategic perspective to enterprise risk management (Cohen et al., 2017:1204).

The importance of risk management and the role of the audit committee in this regard have been covered by the various corporate governance codes. The Treadway Commission focussed on fraudulent financial reporting and the risk thereof and identified the important functions of the audit committee on the company's assessment of and response to the risk of fraudulent financial reporting (National Commission on Fraudulent Financial Reporting, 1987:42). The Cadbury Commission recognised that a system of corporate governance cannot be a guarantee against fraud or incompetence, but the risk can be reduced by making participants in the governance process accountable through safeguards such as audit committees (Cadbury Commission, 1992:s7.2). The BRC requires management to provide information to the audit committee on overall business environment and risks and the audit committee must review the internal and external auditors' methods of risk assessments and the results of those assessments and the emergence or elimination of high risk areas (BRC, 1999:1092-1093).

In South Africa, the King II report included a whole section on risk management and referred to financial risks, operational, and business risks (IODSA, 2002:73). In the King II, risk management is described as:

"... the identification and evaluation of actual and potential risk areas as they pertain to the company as a total entity, followed by a process of either termination, transfer, acceptance (tolerance) or mitigation of each risk" (IODSA, 2002:73).

And the risk management process as:

"The risk management process entails the planning, arranging and controlling of activities and resources to minimise the impacts of all risks to levels that can be tolerated by shareowners and other stakeholders whom the board has identified as relevant to the business of the company" (IODSA, 2002:73).

The King II states that the governing body is responsible to ensure a systematic, documented assessment of the processes and outcomes is done annually for making a public statement on risk management. The King II also provides for the appointment of a board committee or dedicated committee to assist the board in reviewing the risk management process and the significant risks facing the company (IODSA, 2002:31). While it is not recommended in the

King II, it provides for the possibility of delegating it to the audit committee although it is stated the audit committee fulfils a separate function in which assessment of risk management is only part of it. The audit committee should consider the results of risk management and internal control processes and disclosure in this regard. The information obtained by the audit committee can then influence the audit committee to decide on the nature and extent of assurance to be provided by the external and internal audit (2002:76).

The King III expanded on King II and with reference to risk tolerance levels added an additional nine principles related to risk management to be implemented. Principle 4.3 states that the risk committee or audit committee should assist the board in carrying out its risk responsibilities. If the governing body assigns it to the AC, it needs to ensure the audit committee has adequate resources available to adequately deal with risk governance in addition to its audit responsibilities. The risk or audit committee should consider the risk management policy and plan and monitor the whole risk management process (IODSA, 2009:75).

Principle 11 of King IV states that the governing body (council) should govern risk in a way that supports the organisation in the setting and achievement of the strategic objectives. According to King IV, the governing body should evaluate and agree on the nature and extent of risks the organisation is willing to take and approve the risk appetite and limit of potential loss tolerance. The responsibility of effective risk management should be delegated to management, but the governing body must exercise oversight (2016:61, 85). The King IV states if the governing body delegates risk governance to the AC, it must ensure sufficient time is available to fulfil this function. Regardless of whether risk governance is delegated to the AC, the audit committee must oversee the management of financial and other risks affecting the integrity of external reports issued by the organisation (IODSA, 2016:55).

Another important document that guides enterprise risk management was issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO, 2017). The 2017 document build onto the previous 2004 Enterprise Risk Management—Integrated Framework issued by the COSO. The 2017 document links enterprise risk management with strategy and performance and contains the following principles.





**Figure 4.7. Five components and principles of the enterprise risk management integrating with strategy and performance (COSO, 2017:7).**

In the local government environment in South Africa, section 62(1)(c)(i) of the MFMA requires the accounting officer (MM) to take all reasonable steps to ensure an effective, efficient, and transparent system of risk management and internal controls are maintained. Sections 166 (4) of the MFMA requires an audit committee to advise the municipal council, the political office-bearers, the accounting officer, and the management of the municipality or municipal entity on, *inter alia*, matters relating to risk management (RSA, 2003).

In response to various government legislation related to risk management, National Treasury developed a Public Sector Risk Management Framework with different guideline documents including templates and implementation tools for the Public Service. One specific document provides guidance to the audit committee (National Treasury, 2009). According to the guidance document, the audit committee needs to provide counsel, advice, and direction in respect of risk management. Specific responsibilities include acquiring a good understanding of the risk management policy, strategy, implementation plan, and fraud risk management policy. Additionally, to review the risk appetite and risk-tolerance and recommend it for approval. The audit committee also needs to review the completeness of the risk assessment process, the risk profile and management action plans, and the adequacy of risk responses. The audit committee must also monitor progress made with the management action plan and risk management strategy and review and recommend any risk disclosures in the annual financial statements (National Treasury, 2009: 5-7).

Circular 65, issued by National Treasury, also describes the responsibilities of the audit committee related to risk management. According to the circular the AC's responsibilities for risk management should be contained in the audit committee charter. The audit committee must provide an independent and objective view of the effectiveness of the municipality's risk



management and provide feedback to the accounting officer and municipal council on the adequacy and effectiveness of risk management in the municipality (National Treasury, 2012:12-13).

Of the six audit committee charters reviewed five made specific reference to the responsibility of the audit committee related to risk management and four of the five listed detailed responsibilities, more than seven, linking it to internal controls.

Van Der Nest (2006:201), in his study on the effectiveness of audit committees in the public sector national departments in South Africa, reported that respondents and interviewees rated the perceived effectiveness of the AC's risk monitoring process at 63%. The elements assessed included an assessment of management's risk management processes (60%), audit committee processes of communication with management and auditors to understand organisational risks (58%), audit committee processes to assess the risks of material financial misstatements (68%), AC's understanding of the department's key strategic risks and management plans to address these risks (66%), and audit committee procedures to encourage frank dialogue with internal and external auditors regarding risk matters (62%).

The fieldwork results reflected in Chapter 7 provide additional information on the roles and responsibilities of the audit committee including related to risk management.

### My story

Based on my observation and experienced during my time serving on audit committees, the establishment and implementation of risk management has been a long and tedious process at municipalities. At many of the municipalities, the risk management process, system, and information are still in the process of being developed and implemented.

As part of the process, much change management effort had to be made by the IAFs and the Risk Officers to get buy-in from the rest of the municipality's staff. Despite the effort, I still sometimes get the sense that management, in some cases, believe risks are managed on a day-to-day basis as part of normal management functions and the need to have it formally documented in risk registers with likelihood and impact ratings merely add to an already burdening administration. To establish a culture of embracing risk management within a municipality, the leadership and commitment, demonstrated by the municipal manager, is critical.

However, management in municipalities has become much more risk-conscious and oversight more risk-driven with the result that audit committees should be spending more time on risk management oversight than before. But on agendas that are already very full, I am not sure that enough time is being spent on risk management by audit committees.

I believe the audit committee can and should be using their influential powers to assist municipalities in implementing effective and practical risk management systems and processes. Some municipalities have separate risk committees/fraud and risk committees while other municipalities have opted to include risk management as part of the responsibilities of the audit committee. The organisational arrangements can affect the role of the audit committee. If the organisational arrangement is for the audit committee to also function as risk committee, which is the case at some municipalities, it means the responsibilities of the audit committee are much more comprehensive. It would include functions such as review and recommend for the approval of council all the strategic risk management documents including *inter alia* the risk management policy, strategy, implementation plan, risk appetite, risk tolerance and risk identification and assessment methodologies. The audit and risk committee would also need to evaluate the extent and effectiveness of integration of risk management within the municipality, assess the implementation, evaluate the effectiveness of the mitigating strategies, review material findings and recommendations by assurance providers on the system of risk management and monitor the implementation of such recommendations and providing timely and useful reports to the

Council on the state of risk management. The question to be asked is if the audit committee's agenda that is already overstretched and the audit committee also have to fulfil all these risk management functions, is the necessary attention given to it?

Based on my experience I have identified a few areas over and above the general role audit committees play in risk management reflected in this chapter, where the audit committee could consider playing a more prevalent role in risk management. The first being much more involved and providing inputs on the strategic planning level as part of integrated risk management. Secondly to be more involved in advising on quality of disclosure on risk management as part of integrated reporting.

For this to materialise it will be necessary for the audit committee to have the necessary resources including time and expertise devoted to risk management. However, the challenge again will be cost implications to the municipality.

What is very encouraging is that as part of the mix of experience and expertise required for audit committees *risk management* experience and expertise are starting to feature much more.

Section 4.8 of this chapter discussed the role of the audit committee in overseeing internal audit. Another important assurance provider is the external audit. The next section further explores the role of the audit committee in the relationship with external audit.

#### **4.11 Audit committee and external audit**

Auditors form a significant part of the monitoring system of an organisation and can be regarded as an essential component of corporate governance (Cohen et al., 2002:577). The management control philosophy, of which the audit committee has oversight (see section 4.9),

also impacts on preplanning and planning judgements of auditors (Cohen & Hanno, 2000:133).

The support from external audit is vital for an effective audit committee (DeZoort et al., 2002:59). Various studies examining the relationship between the audit committee and external audit and factors affecting it, the auditors' perception of the effectiveness of audit committees, and the role of the audit committee related to external audit including the role of audit committees in resolving auditor client disagreements have been completed. The external auditors, in the early studies by Kalbers (1992a:27) and Cohen et al. (2002:573) found the audit committees to be ineffective, lacking expertise, and struggling with passive communication (Cohen et al., 2002:589). Knapp (1987:586) observed that audit committee members are more likely to support auditors in disputes with management when the audit committee members are themselves corporate managers, the dispute has objective technical standards that support the auditor's position, and the financial condition of the client is weak. Auditors in practice describe their interactions with the audit committee as limited to the auditor reporting on significant issues and not being an active two-way exchange or proactive participation by the AC. The auditors were also of the view that audit committees were not powerful enough to resolve contentious matters with management (Cohen et al., 2002:586). Krishnamoorthy et al. (2002:57) solicited the opinion of external auditors on the effectiveness of audit committees related to quality financial reporting. Of the respondents, 48% indicated audit committees did not have the required financial expertise and 38% expressed concern about the lack of willingness to support the external audit in case of disagreement with management (Krishnamoorthy, 2002:57).

Later research showed a different picture. A study by Cohen et al. (2010:752) found that auditors report a significant improvement in corporate governance after the implementation of the Sarbanes-Oxley Act with audit committees being more active, diligent, knowledgeable, and powerful, however, in some instances still merely playing a symbolic role.

Within the relationship between the external audit and the AC, on the one hand there is external audit that supports the audit committee to fulfil some of its responsibilities and the audit committee that supports the external auditors in fulfilling their responsibilities. On the other hand, the audit committee plays an oversight and advising role regarding external audit on behalf of the governing body.

On the support side, Beasley et al. (2009:103) found external auditors are heavily involved in audit committee meetings and found there is often significant contact between the ACC and

the auditor outside of the formal meetings. West and Berman (2003:333), in a national survey on audit committees in local government, state that audit committees may be required to review and render a judgement on the relationship with external auditors including the role and responsibility of external auditors, the plans, procedures and reports of external auditors, and implications of conclusions from external auditor's reports. West and Berman (2003: 333) further recognise as advisers to the governing body the audit committee could contribute to the city officials rather gaining technical expertise from the audit committee and not external auditors, or the audit committee can aid the professional auditors to validate their conclusions. Salleh and Stewart (2012:1340) found the audit committee plays a mediating role when auditors and management disagree over contentious accounting issues and assist to resolve the dispute without taking sides.

On the oversight and advising part, the study by Beasley et al. (2009:104-1-5) found some audit committees assess the quality of the external audit team (43%) while other audit committees did not evaluate the performance of the auditors. In cases where performance is evaluated, criteria includes evaluating the quality of personnel assigned to the engagement or how the auditor responds to questions from the AC. The researchers conclude that overall audit committees appear to rely quite heavily on the external auditor and the committee generally provides meaningful oversight of the external audit.

Early research by Wolnizer (1995:48) reported that objectives of the audit committee include recommending the appointment of external audit and their fees, reviewing the plans and effectiveness of the auditors, reviewing the quality of the management letter issued by the auditors, determining the independence of external audit, and being informed about disputes between external audit and management. In the literature review, Bédard and Gendron (2010:183) found one of the main responsibilities of the audit committee is to oversee the external audit function comprising of the selection, compensation, work, and independence of the external audit. It was further viewed that effective oversight by the audit committee is expected to strengthen the quality of the audit, which is confirmed by DeZoort et al. (2002:59). The study of Robinson and Owens-Jackson (2009:117) showed that an external auditor is more likely to be supported by a more independent audit committee that has more financial expertise and firm-specific knowledge.

Another key role of the audit committee identified in the research by Beattie et al. (2012:371) is the managing of the relations between companies and their external auditors. Within the management of relations, the level of discussion was considered important and it was found

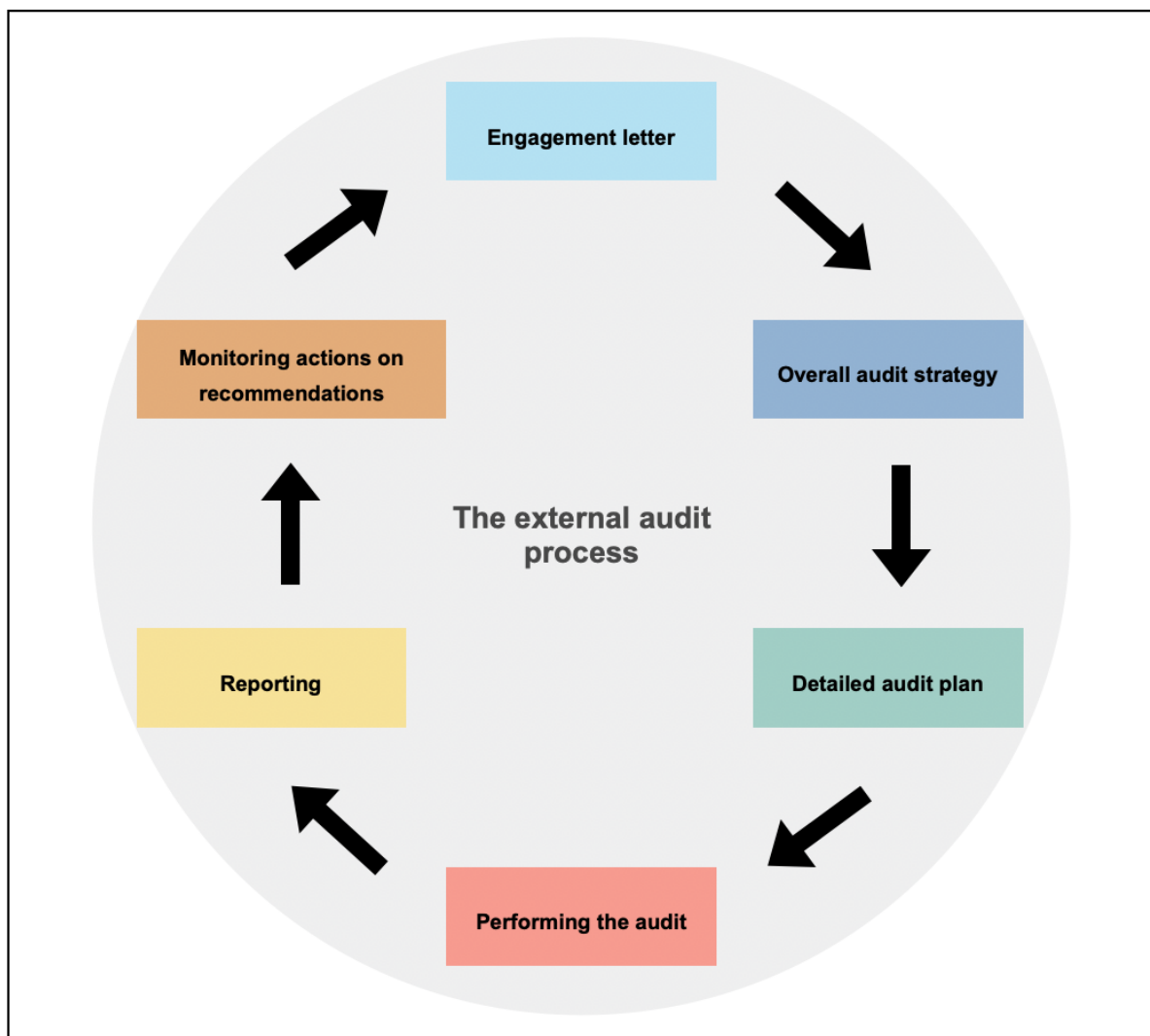
that discussions were significantly higher in cases where audit committee members were former auditors. Discussions also involved the chair rather than the full audit committee.

The role the audit committee must fulfil in the private sector relating to external audit is considerably more onerous than in the public sector. In the private sector, the audit committee is often involved with and oversee the selection, compensation, work, dismissal, and independence of the external audit (Bédard & Gendron, 2010:183, Carcello & Neal, 2003b:95, DeZoort et al., 2002:59). However, in the government sector in South Africa external audits are mostly done by the Auditor-General. In that regard, the audit committee has no role to play in the selection, compensation, dismissal, or ensuring the independence of the Auditor-General staff. This is also acknowledged in the Sector Supplements in principle 8 of the King IV report (2016:84).

King IV requires the audit committee to meet annually with the external auditors without management being present to facilitate an exchange of views and concerns that may not be appropriate for discussion in an open forum (2016:56). The audit committee is also required to provide independent oversight of the effectiveness of the organisation's assurance functions and services with a particular focus on combined assurance (refer to section 4.12) including external assurance service providers, internal audit, and the finance function (2016:55).

Circular 65, issued by National Treasury, include the roles and responsibilities of the audit committee in relation to external audit to include: 1) overview of the scope of work of external audit and the co-ordination with internal audit, 2) review of annual external audit plans, audit fees and other compensation, 3) review of external audit reports including on financial statements and matters and implementation of audit recommendations and municipal council resolutions, 4) review of any interim reports, 5) provide advice to the accounting officer on actions taken relating to significant external audit findings, 6) liaise with external audit on matters the audit committee considers appropriate. The audit committee is also required to ensure external auditors have reasonable access to management and the chairperson of the AC, address any potential restrictions or limitations with the accounting officer and council, and address outstanding matters raised by external auditors (National Treasury, 2012:11). The Public Sector Audit Committee Forum has also issued a guidance document on the role of audit committees in relation to the external and internal audit process. For the external audit process, it describes the specific role of the audit committee in each of the following steps in the external audit process (IODSA, 2015:5-7).





**Figure 4.8. The external audit process** (IODSA, 2015b:4).

In his research on the perceived effectiveness of audit committees at national departments in the public sector, Van der Nest (2006) reported perceived effectiveness of 65% regarding support provided to external audit. The following criteria were used: support from the audit committee for external audit (70%); resolution of differences in audit opinion between management and external audit (70%); review of the management letter issued by external audit (60%); and review of management responses to the management letter (60%).

In the South African public sector context, the audit committee plays a limited role in overseeing the activities of the external audit (AGSA) and the interaction between the audit committee and the AGSA is limited, in most cases, to the meeting where the audit strategy is discussed with management and the meeting where the AGSA presents the audit report and management letter to management. External auditors can support the audit committee, in their oversight role, by identifying internal control weaknesses that the audit committee can monitor



to ensure recommendations are implemented and can also provide advice to management on the implementation of recommendations for their consideration. The audit committee can also support external auditors in fulfilling their responsibilities by, for example, ensuring management provides the external auditors with information required on a timely basis. The audit committee can also play an advisory role in providing feed-back to council on potential matters or matters that occurred that could impact on the audit opinion.

Although the purpose of this study was not to research the relationship between the audit committee and external audit in detail the current practices in local government, South Africa seems non-aligned to research and recommendations in this field, which may be an area for further research.

The role-players forming part of assurance in governance include internal audit, external audit and the audit committee, and the relationship and roles and responsibilities of these three components have been discussed in sections 4.8 and 4.11. The next section further discusses the role of the IAF, external audit, and other role-players as part of combined assurance. The King IV requires of the audit committee to provide independent oversight of the effectiveness of the organisation's combined assurance functions and services.

### My story

In my experience, until recently the interactions between the audit committee and the AGSA was few and far in between and was limited to the meeting when the AGSA presented their audit strategy to management, and only if the audit committee was invited to this meeting. The next interaction would be once the audit was completed and the AGSA presented the audit opinion and management letter to management of the municipality. I am even aware of some cases where the audit committee did not attend these meetings, not being invited, due to the financial cost to the municipality as a result of the audit committee attending the meetings. In those cases, the audit committee received an email with the audit report and management letter and were requested to pose questions or comments on the said documents. This implies that the audit committee was not able to adequately fulfil their role of support and advice through robust discussions and interrogations, identified as being critical for effective audit committees shown by way of empirical evidence and based on discussions during the fieldwork.

I also recall an incident at one of my previous audit committees when, as indicated in the audit committee charter, the audit committee had to review the performance of the external auditors. On an enquiry about this by myself and the request to perform such an evaluation it was opposed by management and the external auditors, as this was considered to be 'between management and external audit'.

Recently, there has been a shift towards management involving the audit committee and specifically the ACC more during interactions with the Auditor-General. This has occurred in the last two years mainly in the areas of the audit fees proposed by the Auditor-General and disagreements between management and the AGSA on interpretation of GRAP and other standards. However, in my personal experience these interactions are appreciated by management but does not have an impact on the results and findings of the AGSA at the end of the day. I am also not sure the current relationship and workings between the AGSA, management and the audit committee result in the spirit of combined assurance being discussed in the next chapter.

## 4.12 Role within the combined assurance environment

Historically, the different assurance providers carried out their assurance activities in isolation (Decaux & Sarens, 2015:57) or as recognised by Schreurs and Marais in silos (2015:73).

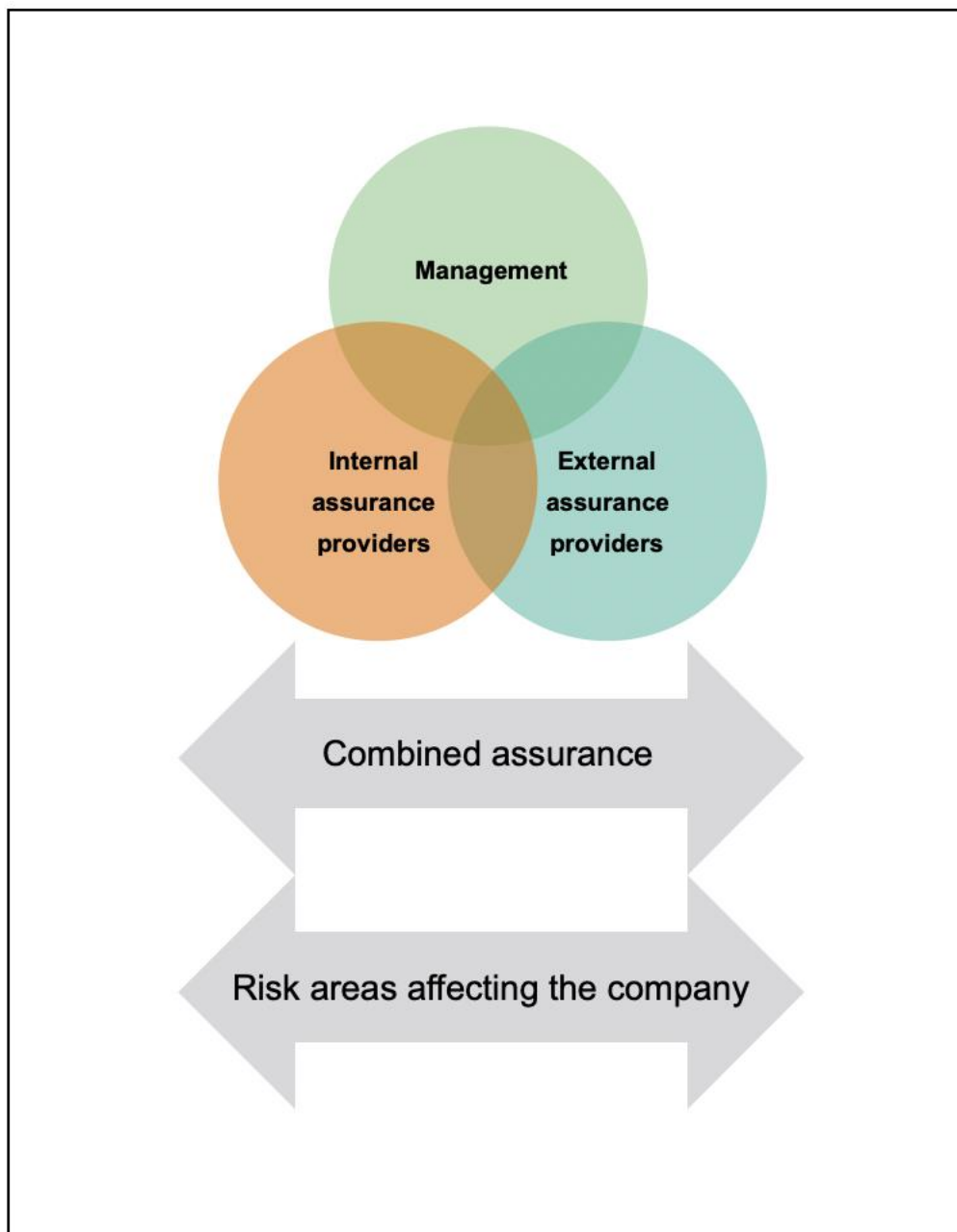
Assurance can be provided by various parties including legal departments, quality assurance, compliance, health and safety, and internal and external audit. This could result in auditees, management, and the governing body suffering from assurance fatigue and in assurance gaps effecting efficient reporting to governing bodies and governing bodies not able to exercise their oversight role appropriately (Decaux & Sarens, 2015:57). Governing bodies are responsible to comment on the effectiveness of risk management and internal control (see section 4.9 and 4.10) and combined assurance can assist with that responsibility. According to Decaux and Sarens (2015:57), the purpose of combined assurance is to provide overall assurance to the governing body on the effectiveness of risk management and internal control systems by coordinating assurance activities from various assurance providers.

In South Africa, the King III introduced combined assurance with the purpose to coordinate assurance activities between various assurance providers, as a leading and recommended practice (Sarens, Decaux & Lenz, 2012: xi). Combined assurance is described in the King III as:

“Integrating and aligning assurance processes in a company to maximise risk and governance oversight and control efficiencies and optimise overall assurance to the audit and risk committee, considering the company’s risk appetite” (IODSA, 2009:117).

Figure 4.9 depicts the different role-players in combined assurance as reflected in King III. Combined assurance aims to optimise the assurance coverage provided by management, internal assurance providers, and external assurance providers on risk areas that affect the company. Principle 3.5 of the King III requires the audit committee to monitor the appropriateness of the combined assurance model to provide a coordinated approach to all the assurance activities and ensure significant risks are adequately addressed (IODSA, 2009:62). Contributors to combined assurance predominantly include internal audit, risk management, quality assurers, environmental and occupational health and safety, external audit, and other external assurance providers and management (IODSA, 2009:96). Combined assurance can provide comfort that significant risks including strategic risks and actions to mitigate the risks have been subjected to adequate assurance procedures (Roos, 2012:32). The King IV recognises that the combined assurance model needed to evolve to become more useful and effective and describes it as:

“A combined assurance model incorporates and optimises all assurance services and functions so that, taken as a whole, these enable an effective control environment; support the integrity of information used for internal decision-making by management, the governing body and its committees; and support the integrity of the organisation’s external reports” (IODSA, 2016:10).



**Figure 4.9. Role-players in combined assurance reflected in King III (IODSA, 2009:62).**

In the King III, the responsibility for monitoring the appropriateness of the combined assurance to ensure significant risks are adequately addressed was assigned to the audit committee (IODSA, 2009:62). In principle 15 of the King IV, the responsibility to set the direction for the arrangements for assurance services and functions is allocated to the governing body. Principle 15 further states the governing body should delegate to the AC, if it is in place, the responsibility to oversee the assurance arrangements. The purpose of the oversight by the audit committee is that it enables an effective internal control environment and supports the

integrity of information for internal decision-making and integrity of external reports (IODSA, 2016:68).

In local government, the council as governing body delegates its responsibility to the audit committee through the approved audit committee charter. As part of the fieldwork the audit committee charters for a sample of the municipalities were reviewed to ascertain the delegated authority and responsibilities with reference to combined assurance. Only two of the six audit committee charters reviewed highlighted the responsibilities of the audit committee under a separate heading *Combined Assurance*. An example of the responsibilities at one of the municipalities read as follows:

The audit committee must oversee the implementation of a combined assurance framework and is applied to provide a coordinated approach to all assurance activities, and in particular “The audit committee shall:

- Ensure that the combined assurance received is appropriate to address all the significant risks facing the [municipality]; and
- Monitor the relationship between all the assurance providers ... “

There are different role-players, such as managers, internal and external assurance providers, in the assurance process and different lines of defence that have been promoted by various professional bodies including the IIA. The different lines of defence model is an easy and effective way to clarify roles and responsibilities related to risk management and control and ensuring the responsibility is shared among different parties (Grant Thornton, 2015:12).

The King IV also requires the governing body to satisfy itself that a combined assurance model is applied to achieve assurance objectives and designed and implemented to ensure the significant risks are covered through a combination of assurance service providers. Assurance providers referred to in the King IV include, *inter alia*, the line functions that own and manage risks, specialist functions that facilitate and oversee risk management and compliance, internal auditors, fraud examiners, external auditors, environmental auditors, and regulatory inspectors (IODSA, 2016:68).

The King IV specifically states the governing body should delegate to the audit committee the responsibility to oversee the combined assurance arrangements. The objective is to enable an effective internal control environment, supporting the integrity of information for decision-making and supporting the integrity of external reports.

King IV states:

“The governing body and its committees should assess the output of the organisation’s combined assurance with objectivity and professional scepticism, and by applying an enquiring mind, form their own opinion on the integrity of information and reports, and the degree to which an effective control environment has been achieved” (2016:68).

Decaux and Sarens (2015:58) identify six important components for combined assurance implementation that will assist the audit committee to exercise their oversight roles. The components include establishing a mature risk management framework, creating awareness around combined assurance, identifying a combined assurance champion, developing an assurance strategy, mapping assurance providers to their assurance activities, and reporting combined assurance findings (Decaux & Sarens, 2015:58).

In South African government, the Auditor-General also reflected on the different roles and responsibilities related to combined assurance in the Consolidated General Report on the Audit Outcomes of Local Government 2013-14. According to the Auditor-General, council is responsible for overseeing and monitoring the information and reports on the financial and service delivery performance of the municipality provided by the MM and senior managers. Council relies on different assurance providers, as part of the combined assurance framework, to provide information and guidance to enable them to oversee and monitor the financial and service delivery performance. One of the important activities the council must perform is to monitor the implementation of recommendations by the audit committee and internal audits with a view to remedial action (Auditor-General, 2015:111).

The Auditor-General also refers to senior management providing assurance by designing and implementing basic financial and performance management controls (Auditor-General, 2015:99). In local government, the MMs need to create an enabling environment for controls to improve by providing effective and ethical leadership. This would include implementing effective human resource management, establishing policies and procedures, designing, and implementing an information technology governance framework, implementing appropriate risk management activities, and ensuring an adequately resources and functioning internal audit unit. The Auditor-General recommends that MMs support the audit committee and ensure Auditor-General reports are responded to (Auditor-General, 2015:100).

Within local government, another committee to provide oversight is the municipal public accounts committee (MPAC). The MPAC is a committee of council that assists the council by considering and evaluating the content of the annual report and make recommendations to

the council when adopting an oversight report on the annual report. The MPAC also needs to examine the financial statements and audit reports and consider improvements, evaluate the extent to which Auditor-General and audit committee recommendations have been implemented, and promote good governance, transparency, and accountability in the use of municipal resources (Auditor-General, 2015:111). Botlhoko (2017:317), in his study developed operational guidelines for MPAC and recognises the need for a sound relationship with the AC.

The Auditor-General also refers to the important role of coordinating and monitoring departments, including those played by the Department of Planning Monitoring and Evaluation, Provincial treasuries, National treasury, the Offices of the Premiers, and the Department of Cooperative Governance (Auditor-General, 2015:103). During the fieldwork of the study, various participants also referred to the need for other departments, like Provincial Treasury, to become more involved from a supportive side, which is further discussed in Chapter 7.

On the other hand, concerns have been expressed about all the different oversight structures municipalities are subjected to (refer to Chapter 7).

The need for co-ordination of assurance activities has been identified early by Mohamed and Hussain (2005:41-42) who noted in 2005 the most cited functions of an audit committee include strengthening internal and external audit functions, co-ordinating the work of auditors, strengthening the positions of non-executive directors, and assisting the board to fulfil its legal obligations. With the inclusion of the requirements of combined assurance in King III and King IV, this need has been addressed. The role of the audit committee related to combined assurance was included as part of the fieldwork and is reflected on in Chapter 7.



## My story

There has been much discussion and promotion of the concept of combined assurance in local government. However, the implementation has been slow and there seems to be a lot of uncertainty around this. To me, the implementation of combined assurance can take municipalities far to address the current frustrations of too many oversight functions, too many reports and administrative compliance to the detriment of service delivery. These frustrations came to the fore during the discussion as part of the fieldwork of this study, but I have experienced it continuously during my time serving on audit committees.

Within the local government there are many oversight bodies playing a role or possible role in the combined assurance field. There are the AGSA, National Treasury, Provincial Treasury, Council, MPAC, MAYCO, portfolio committees, audit committees, IAF and executive management committees, to name but a few.

All these bodies require information and reports to be able to fulfil their oversight and management role. It just makes sense to combine and streamline these efforts to achieve the objectives of oversight and assurance without unnecessary effort.

As a minimum, there should be better coordination between the AGSA and IAF at municipalities. I do understand the objectives of external audit and internal audit differs. I also understand not all IAF are at a required level of competencies to enable the AGSA to rely on the work of internal audit. However, there are areas where a lot of work is being done by the IAF to at least warrant consideration, evaluation, and coordination of efforts, other than just considering it for 'risk identification'. One such area is on performance information (non-financial information) that is audited in detail by most IAF in local government as a result of it being a legislative requirement for the IAF to do. The information is also subjected to detail audit work by the AGSA. Unfortunately, there are continuous, different reasons provided why it is not possible to rely on the work of the IAF.

My plea is - in light of limited resources - including human resources and financial resources that will reduce even more in the future with the impact of the COVID-19 pandemic, let us use the resources we have optimally and not duplicate where it is not necessary.

The next section explores another important responsibility for the audit committee in local government related to performance management.

### 4.13 Role in performance management

The importance of performance management in local government is evident in the legislative requirements included in the Municipal Systems Act, the Municipal Planning and Performance Management Regulations (RSA, 2001b) the MFMA, (RSA, 2001a, RSA, 2001b and RSA, 2003) and various guideline documents issued in this regard.

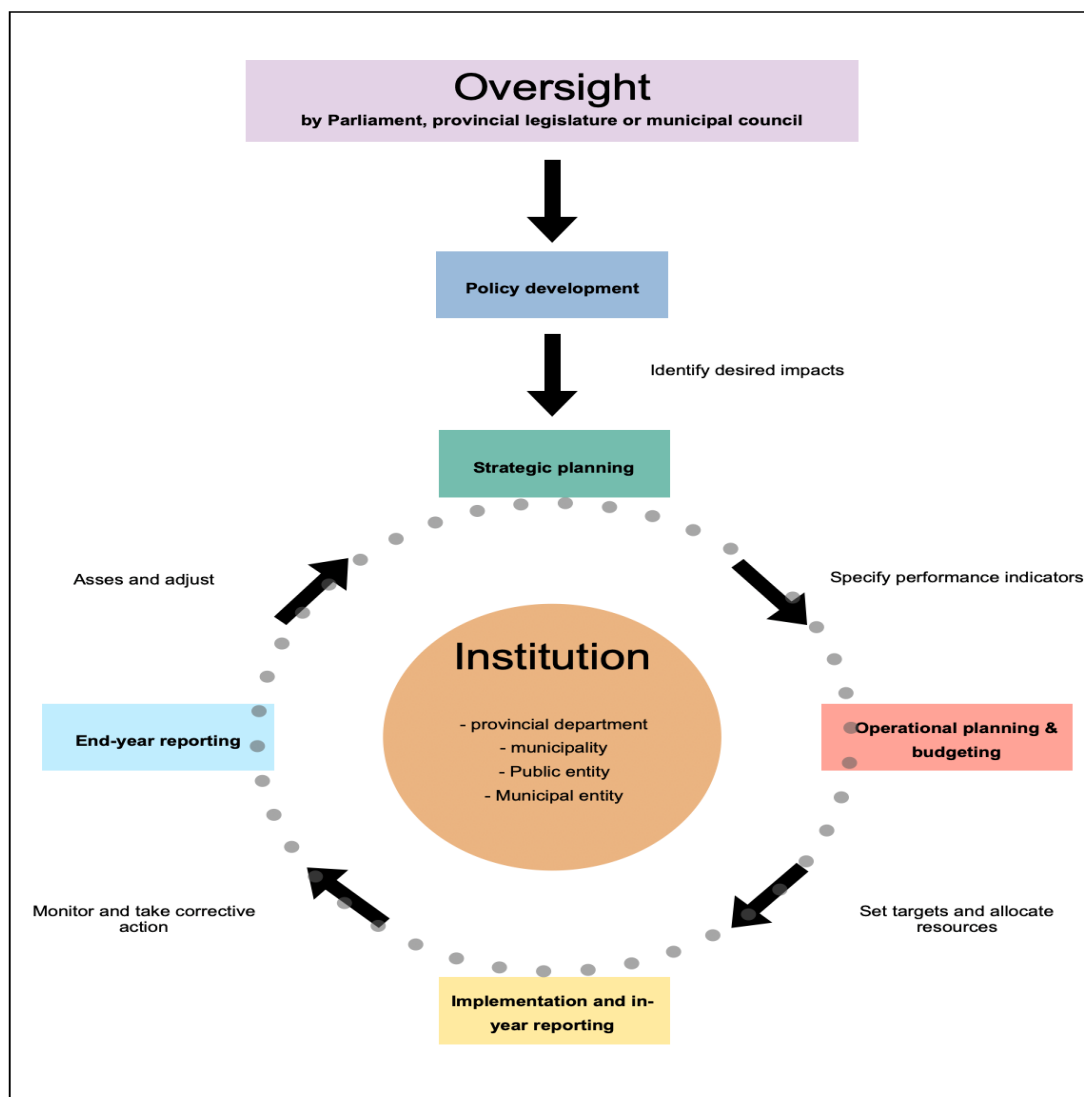
The Framework for Managing programme performance information demonstrates the link between the various components of performance management and was adapted in the PSACF discussion paper. See Figure 4.10 on the role of the audit committee in performance management at municipalities (IODSA, 2019:4). This section of the study describes the legislative requirements and the role and responsibilities of the audit committee during the different performance management phases.

Section 40 of the Municipal Systems Act (32 of 2000) (RSA, 2000) requires a municipality to establish mechanisms to monitor and review its performance management system. Section 41 then lists the core components of a performance management system and section 45 requires the results of performance measurement to be audited by internal audit and by the Auditor-General. Sections 13 and 14 in the Municipal Planning and Performance Management Regulations (RSA, 2001b) contain additional requirements for the monitoring, measurement, and review of performance and the internal audit of performance measurements and the need for internal audit to report thereon to the performance audit committee quarterly. The MFMA, in section 165, also requires internal audit to advise the accounting officer and report to the audit committee on matters relating to performance management (section 165 (2), (b), (v)) (RSA, 2003).

As part of its advisory role to council, management, and other role-players, the audit committee also needs to advise on performance management according to section 166 (2)(a)(v) of the MFMA (RSA, 2003).

What is further unique in the local government environment is that the Municipal Planning and Performance Management Regulations (RSA, 2001b) in section 14 (2) makes specific provision for the annual appointment of an independent performance audit committee (the role of which can be fulfilled by the AC) that must include at least one person who has expertise in performance management. According to section 4 (a), the performance audit committee is required to review the quarterly reports submitted by internal audit on performance

management, review the municipality's performance management system and make recommendations in this regard to council, and submit an audit report to council at least twice during a financial year. In reviewing the performance management system, the performance audit committee must focus on economy, efficiency, effectiveness and impact of key performance indicators and performance targets set by the municipality (section 4 (b)). The performance audit committee may communicate directly with the council, MM, or the internal and external auditors of the municipality concerned, investigate any matter it deems necessary for the performance of its duties, access any municipal records containing information that is needed to perform its duties or exercise its powers, request any relevant person to attend any of its meetings and, if necessary, to provide information requested by the committee (section 4 (c)). Based on the observations in practice, the use of the audit committee for fulfilling the responsibilities of the performance audit committee is a regular occurrence. Figure 4.10 depicts each of the phases in the performance management process.



**Figure 4.10. Planning, budgeting, and reporting cycle (IODSA, 2019:4).**

The guidance by the public sector audit committee forum on the audit committee and performance management recommends the roles and responsibilities in the performance management process should be clearly articulated in the approved audit committee charter. Internal and external audit findings on performance management should be reviewed by the audit committee that should also ensure adequate corrective actions are taken to address the findings. The audit committee should also review and comment on whether there is an appropriate process to review compliance with legislation, guidelines, and best practices relating to performance management (IODSA, 2019:6). With reference to each of the phases in the performance management process included in Figure 4.10, the role of the AC/performance audit committee is as follows:

**Table 4.1: Responsibilities of the audit/performance audit committee linked to performance management phases**

Performance management phases	Audit/performance audit committee responsibilities
Strategic planning and operational planning	Oversee and advise on credibility and strategic relevance of information in the Integrated Development Plan (IDP) and Service Delivery and Budget Implementation Plan (SDBIP) before submission.
	Advise on KPI's and targets including strategic nature, relevance and appropriateness, verifiability, and measurability, being well-defined and specific and achievability of the targets. Focus should be on the economy, efficiency, and effectiveness of KPI's and targets.
	Review and comment on alignment between planning documents, budgets, and performance agreement.
	Review changes to planning documents for reasonableness and impact.
Implementation and in-year reporting	Review compliance with in-year reporting requirements.
	Ensure municipality has implemented systems for monitoring performance, the performance management system and performance information generated by the system.
	Review adequacy of work performed by internal audit related to performance management and relevant legislative requirements.
	Review the performance management system and make recommendations by way of a report to the council twice a year.
	Advise and make recommendations to improve performance and performance management.
Reporting	Review and comment on annual performance report included in the annual report and ensure timely submission to the Auditor-General.
	Review and comment on annual report in accordance with stipulated timeframes.

Adapted from principles for the audit committee's role in performance management (PSACF, 2019: 5-6).

Specific legislative requirement to the last step in the performance management process – reporting - requires that an annual performance report reflecting the performance of the municipality against targets and the previous year's performance and measures to improve performance be prepared and included in the annual report. The Municipal Systems Act (32 of 2000) (RSA, 2000), further requires that the performance report should include development and service delivery priorities and the performance targets for the next financial year (RSA, 2001 a: section 46). Section 121 (3) (f) of the MFMA (RSA, 2003) requires that the annual

report contains a statement by the accounting officer (MM) on the assessment of performance against the measurable objectives of revenue collection from each revenue source and each vote in the budget.

King IV recognises the municipalities core purpose, risks and opportunities, strategy, business model, performance, and sustainable development are all inseparable elements of the value creation process (IODSA, 2016:81), and the audit committee has a key role to play in advising council in this regard.

King IV further requires council to ensure that reports issued by the municipality enable stakeholders to make informed assessments of the municipality's performance and its short, medium, and long-term prospects (IODSA, 2016:82). As part of the fieldwork the role of the audit committee in performance management was further explored and presented in Chapter 7.

That the roles and responsibilities of the audit committee regarding performance management are considered critical for the audit committee to have a clear and detailed understanding of the mandate and business of the entity can be appreciated. The need for audit committee members to understand the local government environment and the municipalities itself was emphasised as a critical feature of the audit committee by various stakeholders during the fieldwork (refer to Chapter 7).

The next section explores the role of the audit committee related to compliance obligations.



### My story

Performance management has always been my pet subject in the governance area and in many audit committees I have been selected to serve has been based on my performance management skills and experience. Although financial information and financial management is key, so is the actual non-financial performance side. The core of municipalities is service delivery, and the performance management is therefore extremely important. When one reflects on the role and responsibilities of audit committees in local government, according to the legislation and the governance code, it is comprehensive.

Unfortunately, at most municipalities' performance management does not get the attention it deserves. Over the last 20 years or so, audit committees in local government have become more involved with performance management. The main reason is that in South Africa, non-financial information is also subjected to audit by the AGSA. Due to the over-emphasis on 'clean audit opinions', the audit committees had to get more involved with performance information because it could affect the AGSA audit opinion and therefore cause possible reputational damage to audit committee members.

But I ask myself, is this the right reason to pay attention to this important area - just to get a positive audit opinion? Or should we as audit committee members be more concerned with assisting and advising the municipality in:

strategic planning, identifying appropriate key performance indicators, identifying strategic risks, and managing performance. Is that not what was intended by the requirements in the Municipal Systems Act and the governance codes?

But unfortunately, again, lack of resources and cost containment measures at local government level prevents the audit committees from contributing effectively in this important area.

In most municipalities, the audit committee and performance audit committee have been combined, which is allowed by legislation. However, now performance management and information are simply becoming another item on the already full agenda that needs attention.

At a previous audit committee, a decision was made to split the audit and performance audit committee. After this there was a huge improvement in the quality of information, the extent of interrogation and debate and the audit findings. Unfortunately, due to cost saving measures, it was subsequently decided to merge these two committees again. It was heartening during the fieldwork to hear from two municipalities that have made the decision to split the two committees and hearing from the people involved the benefit that is gained from this.

## 4.14 Role in relation to compliance obligations

The public sector and local government are highly regulated in South Africa. Section 166 (4) of the MFMA regarding the role of the audit committee includes to advise the municipal council,

the political office-bearers, the accounting officer and the management of the municipality on matters relating to compliance with the MFMA, the Annual Division of Revenue Act (4 of 2020) (RSA, 2020), and any other applicable legislation (RSA, 2003). Compliance of municipalities to legislation is subjected to rigorous scrutiny by the Auditor-General and the audit reports of municipalities, distinguish between three main categories including audit of performance management, audit of compliance to legislation and internal control over and above the financial statements. The King IV, in one of the governance principles, states that the council should govern compliance with applicable laws and adopted, non-binding rules, codes, and standards in a way that supports the organisation being ethical and a good corporate citizen (IODSA, 2016:85).

Audit committees should also consider the oversight of compliance as an essential part of their responsibilities. A study by Grant Thornton (2015:7) on the consistency in priorities between CAEs and the audit committee revealed that there is an inconsistency between the focus by internal audit and what the audit committees considered to be high priorities. Although internal audit focused on improvement opportunities, audit committees considered focus on financial controls and compliance activities to be more important. The view of different stakeholders on the roles and responsibilities and what should or are the high priorities was solicited during the fieldwork and is reflected on in Chapter 7. Interestingly, compliance was never specifically highlighted as a priority area despite it being one of the findings by the AGSA that will result in a modified audit opinion. Nzewi (2017:11) recognise compliance to legislative and regulatory frameworks has become a principal challenge to municipal performance and service delivery.

Considering the above legislative requirements, corporate governance guidance and emphasis by the Auditor-General compliance to legislation is an important oversight and advisory area for the AC. However, no further guidance is provided to the audit committee on the specific procedures or steps to be conducted in this area of their responsibility.

An extract from an audit committee charter of one of the municipalities that formed part of this study revealed the following responsibilities relating to compliance:

The [audit committee] shall ensure that the management of the municipality has the necessary mechanisms in place to ensure compliance with pertinent laws and regulations and is conducting its affairs ethically. This must include maintaining effective controls against conflicts of interest, fraud, and corrupt practices.

The specific steps involved in carrying out this responsibility shall include:

- Review the effectiveness of all systems for monitoring compliance with relevant laws and regulations in terms of the [audit committee's] mandate and authority; and



- Review whether all regulatory compliance have been considered in the preparation of the financial statements and performance management processes and reports.

At most of the audit committees with which the researcher is involved, management uses a self-assessment software package that includes various legislative requirements and report-back on a quarterly basis to the audit committee where management has not adhered to compliance requirements. The reasons for non-compliance are presented to the AC.

During the fieldwork phase, the different audit committee charters, Auditor-General reports, and audit committee reports were further analysed on this area of responsibilities and the results are reflected in Chapter 7.

#### **4.15 Role in relation to information technology governance**

Any successful organisation needs quality information that can be relied on. For information to have integrity there needs to be a sound system of internal control of which information technology controls are at its core. Information technology (IT) and the rapid development in this area have a significant impact on any organisation. IT platforms are becoming more complex and there is a continuous need to assess the impact of technology on an organisation and to monitor responses to identified risks by way of the control environment. As recognised by Flowerday and von Solms (2005:604):

“A majority of companies today are totally dependent on their information assets, in most cases stored, processed, and communicated within information systems in digital format. These information systems are enabled by modern information and communication technologies. These technologies are exposed to a continuously increasing set of risks. Yet, management and stakeholders continuously make important business decisions on information produced .... Therefore, risk management, including a system of internal controls, has become paramount to ensure the information’s integrity ....”.

King IV states:

“Technology is now part of corporate DNA. Thus, the security of information systems has become critical. Technology governance and security should become another recurring item on the governing body’s agenda” (IODSA, 2016:6).

The Chartered IIA makes the following statement on the evolvement of risks:

“Increasingly, the key risks for many organisations are not seen to be the traditional financial risks, such as fraud, weak financial reporting, or inadequate financial controls. Rather they are technologically driven risks relating to cyber or data protection” (IIA, 2019:6).

The study by Ernst and Young (2018:40) on technology and the audit committee also recognises the pressure on companies to keep data safe that makes cyber risk a prominent item on the audit committee agenda.

DeZoort et al. (2002:66-67), in their early research on the effectiveness of audit committees, referred to the expanding role of the audit committee with specific reference to oversight of the information technology domain and concluded the ambiguity in audit committee responsibilities and capabilities in the area of information technology justified further research.

Hadden (2002) also acknowledged the need for research and examined the role of the audit committee in monitoring the IT risk. Hadden’s (2002) research was also the first study to define increased audit committee effectiveness as increased perceived audit committee oversight of IT-related risks. The results of her research indicated that audit committee information technology expertise, the size of the company, and the financial services industry classification combined with experience of the COBIT model are positively related to the AC’s perceived oversight function of IT risks (Hadden, 2002:94).

Marx (2008:83), on his study of audit committee effectiveness in South Africa, also recognises the development of information technology has exposed entities to many and new forms of risk. He emphasised the important role audit committees need to play as part of its oversight responsibility of internal control and risk management. According to him, the effective audit committee must have a proper understanding of IT issues and risks (Marx, 2008:82).

Research by Hadden, Hermanson and DeZoort (2011:1), as part of an exploratory study, examined the role of the audit committee in overseeing IT risk. Their study found there is little audit committee emphasis on oversight of IT risks, and where audit committees are involved with overseeing IT, it focusses on traditional risks, being monitoring, and limited focus on IT and implementation. Hadden et al. (2011:1) found that the extent of IT oversight is positively associated with the member’s audit experience and, like the earlier study by Hadden, found a positive association between oversight and familiarity with the COBIT model. The researchers also encourage further research in the degree to which audit committees accept responsibility for IT oversight, how the audit committees enhance their IT expertise, and what other factors

may be associated with greater information technology oversight by the audit committee (Hadden et al., 2011:8).

During the fieldwork, the role of the audit committee in the IT environment was further explored and the challenges to obtain IT expertise in the audit committee were raised by some of the participants. Their views are expressed in Chapter 7, section 4.3.1.

However, the audit committee does not only need to oversee information technology risk and internal controls, it also needs to oversee the relevance of the work performed by internal audit. A study by Grant Thornton (2015:11) indicated that CAEs and audit committees recognise the increased concerns about data privacy and security including cyber risks. The AC, as part of its oversight responsibility in response to the risks, requests regular assessments and reporting from management, the audit committee reviews policies, procedures and controls related to data security, and ensures ongoing monitoring and testing of the control environment (Grant Thornton, 2015:11). The ACCs in the study by Ernst and Young (2018:4) also indicate that during audit committee meetings, the audit committee reviews cyber risk and monitors the risk environment using, for example, dashboards.

There is also an expectation for internal auditors to use digital tools to add value and enable effective audit processes, which is another area the audit committee should oversee and advise on. Ernst and Young (2018:4) discuss how technology is helping audit committees to see the bigger picture. According to the article, the emergence of new tools, techniques, and technology in auditing is resulting in improved assurance and insights:

“The real game changers are the new technologies that are being applied to the audits themselves, because of the far-reaching insight they offer to audit committees. Data analytics is transforming the way that audits are conducted” (Ernst & Young, 2018:2).

Some of the ACC in the study by Ernst and Young recognise, through the results of data analytics, that the audit committee can understand why something has happened and then question management thereon. It also helps for higher quality discussions to take place between the audit committee and the auditor (Ernst & Young, 2018:2). To enable higher quality audits, it is necessary for high-quality technological tools but also higher-quality data sets.

The Center for Audit Quality, affiliated to the American Institute of CPAs, issued an oversight tool to assist audit committees with the oversight of and involvement with emerging technologies used in financial reporting. The tool includes questions the audit committee can ask to fulfil their oversight responsibilities (Ernst & Young, 2018:2).

In South Africa, the King IV as one of the principles of governance state:

“The council should govern technology and information in a way that supports the organisation setting and achieving its strategic objectives” (IODSA, 2016:62, 85).

The King IV then continues with eight recommended practices on IT and the oversight of technology and information management (IODSA, 2016:62-63).

The Guide for the audit committee in local government, issued by National Treasury, states that the audit committee needs to provide advice on information technology governance, controls, access and safeguarding of information. However, it provides for the possible need to acquire specific expertise from within or outside the municipality to assist with the recommendations on systems and controls. Examples of where the audit committee could provide advice include the appropriateness of disaster recovery and continuity plans supporting information technology risks, regular testing and evaluation of plans, systems, and processes (National Treasury, 2012:14).

During the fieldwork, the role of the audit committee in relation to information technology was further explored and is reflected on in Chapter 7. The next section reflects on the role of the audit committee in overseeing and advising on ethics management in local government in South Africa.

#### **4.16 Role in relation to ethics management**

Business ethics and ethics management is a discipline on its own and has received renewed interest from business leaders, academics, and society as a result of business scandals and failures, fraudulent financial reporting, and corporate governance failures. However, the importance of ethics and ethical conduct in business can be traced to ancient times (Shaw, 2014:4).

This section will focus on the responsibilities of the audit committee on ethics and ethics management within South African local government. The section will address the meaning of business ethics, reflect on some of the research completed on audit committees and ethics, and then explore the ethical requirements relevant for audit committees.

Business ethics is described by Shaw as the: ‘study of what constitutes right and wrong, or good and bad, human conduct in a business context’ (Shaw, 2014:4).

Kretzschmar, Prinsloo, Prozesky, Rossouw, Sander, Siebrits, Woermann (2015: 20) state that business ethics focuses on what is good and right in economic activity and engages in a moral analysis of economic practices and activities.

King IV describes ethics as:

“Considering what is good and right for the self and the other and can be expressed in terms of the golden rule, namely, to treat others as you would like to be treated yourself. In the context of organisations, ethics refers to ethical values applied to decision-making, conduct, and the relationship between the organisation, its stakeholders, and the broader society” (IODSA, 2016:12).

In the discussion on morality and law, Shaw (2014:7) identifies laws to include statutes, regulations, common law, and constitutional law. Due to limitations in time and knowledge, legislatures often establish boards and agencies whose responsibility is to issue detailed regulations that cover certain types of conduct (Shaw, 2014:7). Shaw also refers to a professional code of ethics that are rules supposed to govern the conduct of members of a profession.

Within the local government context in South Africa, Schedule 2 of the Local Government Municipal Systems Act (32 of 2000) (RSA, 2000) includes a code of conduct for municipal staff members (RSA, 2001 a). The MFMA, in section 112 (1)(m)(ii), requires that the supply chain management policy must include measures to promote ethics of officials and other role players involved in municipal supply chain management (RSA, 2003). The Municipal Regulations on Financial Misconduct procedures and criminal proceedings issued in terms of the MFMA provide for the establishment of a disciplinary board to investigate allegations of financial misconduct in the municipality and monitor the implementation of disciplinary proceedings against an alleged transgressor (RSA, 2003). The Regulations makes provision for a member of the audit committee to form part of the disciplinary board (RSA, 2014: section 4 (6) (b)).

King II recommends that every company should have a code of ethics and the third King Report on Corporate Governance places great emphasis on ethics and states ethics is the foundation of, and reason for, corporate governance (IODSA, 2009:21).

The King IV as one of the principles of governance state:

“The council should govern the ethics of the municipality in a way that supports the establishment of an ethical culture” (IODSA, 2016: 81).

One of the earlier studies on the prevalence, role, composition, and the effectiveness of audit committees in local government in the USA also covered ethics (West & Berman, 2003:332-333). According to the survey, there is an expectation that audit committees will play a role in dealing with ethical issues related to financial management. Best practices in the area of ethics include the presence of an ethical code of conduct and implementation of ethics management practices, for example, employee training, ethics policies, monitoring the compliance thereof and enforcing discipline. The ethics review by audit committees would include to review and monitor the responsibilities of external audit and internal audit to detect errors, illegalities, abuse, and noncompliance. Therefore, audit committee members and auditors need to be familiar with ethical requirements and remain vigilant to detect any ethical issues arising. It is further recommended that audit committees should ensure that proper controls are in place and that risk factors are recognised and minimised. The audit committee should also review management's corrective actions to correct irregularities or illegal acts (West & Berman, 2003:332-333). The study refers to different ethics management strategies the audit committee should engage with including the review, approval, and assessment of the ethical code and the process for administration, dissemination, and enforcement of the code. Furthermore, it should assess the ethics training and monitor ethical compliance. However, the study by West and Berman (2003:355-356) found that audit committees were actively seeking to detect ethical wrongdoing without paying attention to broader ethical concerns.

According to Marx (2008:84), one area that entered the evolving role of the audit committee is the responsibility to monitor ethics compliance within the organisation. According to Marx and Els (2009:5), an effective functioning audit committee can play an important role in assisting the governing body to improve business ethics. The governance of the ethical performance consists of four dimensions, namely determining the ethical risk of the company, codifying the ethical standards of the company, institutionalising ethical standards in the company, and reporting the ethical performance of the company. As part of the responsibilities of the AC, they would need to oversee the governance of the ethical performance and provide advice in this regard (Kretzschmar et al., 2015:185-186). It is also a requirement for internal auditors to conduct ethics audits (Jackson, 2006:40), and since the audit committee needs to oversee the work of internal auditors, it will be necessary for the audit committee to review the work internal audit conducts on ethics management.

Marx and Els (2009) conducted research in South Africa on the role of the audit committee in strengthening business ethics and protecting stakeholders' interests. The researchers provide reasons why the audit committee is ideally suited to oversee and strengthen ethical compliance: 1) as a result of their status and seniority (focused structure), 2) integrates with other oversight responsibilities including compliance, 3) audit committee members' training and education, and 4) professional obligation of audit committee members' to act ethically. In the interaction of the audit committee with internal and external audit, the audit committee can obtain useful information to assess ethics management in the organisation (Marx & Els, 2009:6-7).

The responsibilities of the audit committee in strengthening ethics can include setting the right 'tone' at the top due to the important role as sub-committee of the governing body, as well as monitoring the development and implementation of ethics policies and codes and the reporting. According to Marx and Els (2009:8), the audit committee should have a separate agenda item that questions internal and external auditors on business ethics compliance and any findings on business ethics. The audit committee should also consider the need for ethics audits to be performed from time to time. Marx and Els (2009:8) recommend that monitoring of ethics should happen at normal audit committee meetings, but serious transgressions should immediately be reported to the ACC that should decide on further action to be taken.

According to the IIA (2014:9), the audit committee should review and provide oversight on the systems and practices management implement to set and retain high ethical standards, management's monitor of the compliance, and whether management quickly identifies and addresses legal or ethical violations.

Marx and Els (2009) found that most ACCs believe their audit committees are effective in fulfilling their responsibilities regarding business ethics. However, the researchers raised their concern on a significant number of audit committees not reviewing compliance with the code of ethics although in most cases the audit committees review the whistle-blowing information. The annual reports also lacked information by their audit committees on their responsibilities performed regarding business ethics.

Thomas and Purcell (2019:418), recognise ACs can monitor self-interest risk conflicts of management against legislation, societal norms and community expectations. They state ACSs can provide behavioural oversight of governance processes despite it not being possible to legislate for integrity and honesty.



As part of the fieldwork and the review of the audit committee reports, annual reports and the audit committee charter, the fulfilment of audit committee responsibilities regarding ethics is further explored and reflected on in Chapter 7. Another area of responsibility closely associated with ethics is fraud and the next section discuss the responsibility of the audit committee related to fraud.

#### **4.17 Role in relation to fraud**

The literature review in Chapter 2 refers to various studies on audit committee characteristics and fraud. One of the earlier studies on audit committees and fraud was completed by Abbott et al. (2000:55, 61), who studied the association between audit committee independence and activity and fraudulent or misleading financial reporting. They found that independent audit committees that met at least twice per year were associated with a decreased likelihood of fraud and nonfraudulent misstatement. Another study by Abbott et al. (2000:55, 61) found that audit committee expertise and independence are negatively associated with the incidence of fraud but could not find a significant relationship between meeting frequency and fraud. Persons (2009:284) found firms with larger and more independent audit committee that met frequently were less likely to engage in fraudulent financial reporting (2009:284). Brazel (2018:13) concludes that not all forms of audit committee expertise may be beneficial to lower fraud risk but recommends that more research is needed to determine if audit committee industry expertise is related to fraud risk.

From the research, it is clear there is a positive link between the existence and characteristics of audit committees and a reduction in fraud. However, it is important to reflect on what the audit committees' responsibilities related to fraud encompass. Braiotta (2004) describes some of the responsibilities related to fraud include informing and providing assurance to the full board of any indications of possible fraud and illegal acts and corrective actions taken by management. It is also expected of the audit committee to have discussions with external auditors on fraud-risk areas and for the audit committees to be informed about fraud findings. Effective oversight of fraud risk areas require the audit committee to complete a profile worksheet with the details of the entity's potential fraud-risk areas and address a set of representative questions for pre-audit and post-audit meetings (Braiotta, 2004:339). Braiotta, Gazzaway, Colson and Ramamoorti (2010) also state it is reasonable to expect of the audit committees to include a statement of the responsibility to have discussions with external

auditors on fraud as part of the audit committee charter and to disclose the fulfilment of this responsibility. The authors further identify the need for the audit committee to have knowledge about the business model and industry, business risks and internal control environment, policies and procedures for detecting fraud and illegal acts, accounting industry practices, complex business transactions, significant contracts and the financial reporting process to adequately plan a review of the fraud risk areas (Braiotta et al., 2010:299).

Although management has the responsibility to put systems and processes in place to prevent and detect fraud, internal audit adds value to improve the control and monitoring environment in organisations to detect fraud. According to Asare (2009:23), audit committees need to work closely with internal auditors in fraud risk evaluations and investigations.

In South Africa, Marx (2008) also recognises the important part the audit committee can play in the prevention and detection of fraud through their oversight of the system of internal control, risk management, and internal and external audit functions. He states that it can be achieved by supporting an ethical climate and demonstrating an attitude of zero tolerance towards fraud and unethical conduct (Marx, 2008:73).

According to the King IV report, the audit committee should disclose their view on the effectiveness of the design and implementation of internal financial controls and the nature and extent of weaknesses in the controls that resulted in material financial loss, fraud, corruption, or errors (IODSA, 2016:56).

During the fieldwork, the extent to which audit committees adhere to the requirements relating to their responsibilities on fraud is further investigated and presented in Chapter 7.

To demonstrate the fulfilment of responsibilities, the audit committee needs to report on the activities and various requirements and guidance in this area are provided. The next section covers audit committee communication and reporting.

#### **4.18 Communication responsibilities**

The importance of communication in an effective audit committee has also been prevalent in research. Communication includes open lines with management, internal auditors, external auditors, and other stakeholders. One of the effective ways audit committees can demonstrate fulfilment of their responsibilities is through the audit committee report. This section presents

research on audit committee communication and reporting, including the shortcomings, the importance of the audit committee report, and guidance on what information should be included in the audit committee report.

Carcello et al. (2002:291) completed a comprehensive study comparing the disclosures in the audit committee report with the disclosures in the audit committee charter. They found that what audit committees say they are doing in their reports differ from what the charters say the committee should be doing. Their study included mandated audit committee disclosure and voluntary disclosure of audit committee activities. The researcher found a high level of compliance with mandatory disclosures, although voluntary disclosures were more prevalent for larger companies and those with independent audit committees. They identified the need for reforms in audit committee reporting to include areas such as review of interim reports, number of audit committee meetings, and audit committee oversight of interim reports (Carcello et al., 2002:291).

One of the requirements for listed companies in the United States is for the audit committee to include an audit committee report in the proxy statement and state if they have fulfilled their responsibilities. The purpose of enhanced audit committee disclosure requirements attempted to improve the transparency of oversight, provide additional motivation for audit committee members to effectively discharge their duties, and promote investor confidence (Carcello et al., 2002:292). The importance of the audit committee report from a legal perspective has also been identified as important due to the concern about the potential liability risk associated with audit committee charters and reports (Carcello et al., 2002:292). The only legislative requirement regarding audit committee reporting in South African local government is contained in section 121 (3) of the MFMA (RSA, 2003), which requires the annual report of a municipality to include any recommendations by the AC. The need for the audit committee in local government to make a statement on the fulfilment of responsibilities is not contained in legislation. However, the template for an audit committee report, issued by National Treasury, include the following statement: 'The Audit Committee also reports that it has adopted appropriate formal terms of reference as its Audit Committee Charter, has regulated its affairs in accordance with this charter and has discharged all its responsibilities as contained therein, except that we have not reviewed changes in accounting policies and practices' (National Treasury, n.d.).

This research analysed the audit committee charters and reports of the selected municipalities for a better understanding of what the audit committees are currently doing and how this

compares with what the audit committee is required to do. The results of the analysis are included in Chapter 7.

Beattie et al. (2012:354) refer to a survey conducted in 2011 that suggests audit committee reporting fails to comply with requirements of the corporate governance code in the United Kingdom, where only 33% of the audit committee reports covered the assessment and effectiveness of external auditors (2012:354).

In 2014, KPMG issued the results of a survey of audit committee reports that found variation in style and depth of audit committee statements and recognise the difficulty in drafting these reports. KPMG found in some cases detailed narratives by the audit committee outlining the key risks, why it was an issue for the company, the evidence the audit committee considered, and how the audit committees reached their conclusions, equating this to best practice. According to KPMG (2014:10), this showed the audit committees being proactive in, for example, seeking information from management instead of just reacting to information that was provided to them. Other audit committee reports would state reliance on management's views without providing any further explanation, which gives the impression of a passive audit committee.

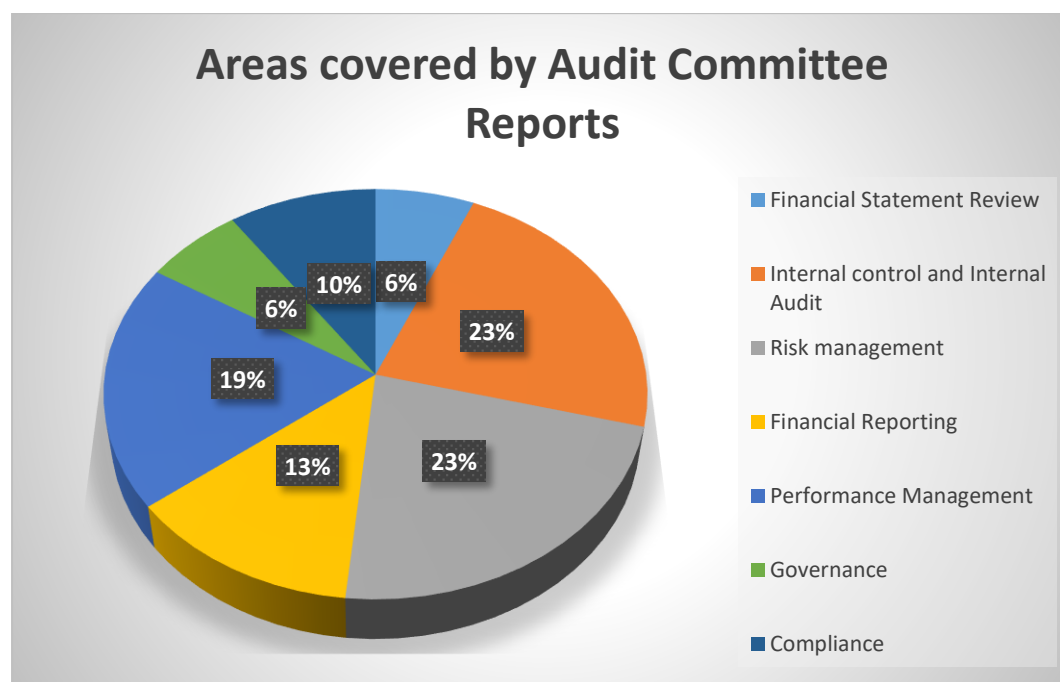
In 2015, the National Association of Corporate Directors (NACD) made a call for action to enhance audit committee reports:

"This 'Call to action' is based upon the simple premise that, given the importance of the audit committee's responsibilities ... it is important ...to understand and have confidence in the audit committee's work. The annual audit committee report ... is the principal source of public audit committee related information other than its committee charter. Public disclosures are the primary channel through which audit committees can educate investors and other stakeholders about their critical responsibilities and demonstrate their effectiveness in executing those responsibilities" (2015:3).

Despite the importance of audit committee reports, research in the area is limited (Reidenbach, 2013:2). Nashwa (2005:43) recognises the necessity of the audit committee to prepare and submit an annual report to the full governing body that identifies how the audit committee discharged their responsibilities. Nashwa (recommends the report should also present significant accounting, internal control (2005:43), and compliance issues, identify the authority and responsibility of the AC, refer to the review of the financial statements, annual reports, and accounting issues and the management letter, internal controls, and compliance.

In his study on voluntary disclosure in the audit committee report, Reidenbach (2013:61) concludes that voluntary disclosure is a useful signal to shareholders of the monitoring effort of the audit committee being the primary communication channel between the shareholders and the audit committee. He also concluded that the level of voluntary disclosure is associated with the financial expertise and compensation scheme of the ACC (2013:63) and information on the results of monitoring of management and the auditors by the audit committee can be very valuable (Reidenbach, 2013:2). Trueman (1986:53) states that voluntary disclosure is a credible signal of ability. If audit committees are actively monitoring the entity, it might be beneficial for them to report to the stakeholders as part of the annual report, being a public document with easy access.

Roos (2017:129) studied the scope, accuracy, and comprehensiveness of 31 audit committee reports in South African local government. The study analysed the information reported by audit committees, the consistency of matters raised by the Auditor-General in the audit reports and audit committee reports, and whether the information included in the audit committee reports was sufficient to demonstrate fulfilment of responsibilities. The following figure depicts the areas covered by audit committee reports in the study by Roos (2017).



**Figure 4.11. Areas of statutory duties and responsibilities covered in audit committee reports (Roos, 2017:137).**

The analysis showed that audit committee communication related mostly to the traditional role of the AC, including risk management review, internal control and internal audit, and

performance management. Statutory duties relating to financial statement review, efficiency and effectiveness of internal control, and overall compliance were found to be limited (Roos, 2017:141). The analysis found broad inconsistencies between the issues reported by the audit committee and those reported by the auditors (Roos, 2017:142). It should be noted that the analysis was based on the 2013/14 financial year reports and there is a possibility that all these findings are not still relevant. Coetzee and Msiza (2018:95) studied AC best practice disclosure in different cluster including municipalities and recognised the need for improvements. As part of the fieldwork, for the selected municipalities, a detailed review of the information contained in the audit committee reports was conducted and is included in Chapter 7.

Various recommendations on the content of audit committee report have been made over the years. In their study on audit committees, Brennan and Kirwan (2015:467) mention the importance of audit committees saying what they did (praxis) and not just what they do (best practice). They further refer to the importance of language used in the audit committee report and the need through the wording to instil confidence and trust in the work performed and the results thereof (Brennan & Kirwan, 2015:467).

In South Africa, the King IV requires the audit committee to disclose the following in relation to each committee of the governing body: overall roles and associated responsibilities and functions; composition including each member's qualifications and experience; any external advisors or invitees that regularly attend meetings; key focus areas during reporting period; number of meetings held and attendance; and whether the committee is satisfied that it has fulfilled its responsibilities (IODSA, 2016:55). Specific requirements for the audit committee report include:

- A statement on external audit independence with specific reference to the provision of non-audit services, tenure, rotation, and changes in management that may mitigate familiarity risk.
- Significant matters related to annual financial statements, and how they were addressed by the committee.
- Audit committee's view on the quality of external audit.
- Audit committee's view on the effectiveness of the CAE and the internal audit arrangements.
- Audit committee's view on the effectiveness of internal financial controls and the nature and extent of significant weaknesses that resulted in material financial loss, fraud, corruption, or error.

- Audit committee's view on the effectiveness of the CFO and finance function.
- The arrangements in place for combined assurance and the effectiveness thereof.

Within South African local government, there is no statutory requirement for audit committees to include an audit committee report in the Annual Report. Sections 121 (3) (i) and 121 (4) of the MFMA requires the annual report of a municipality to include audit committee recommendations to the municipality (RSA, 2003, National Treasury, 2012).

Circular 65 issued by National Treasury (2012) states the ACC should report on a quarterly basis to the council on the operations of the audit committee and the report should include a summary of work performed by internal audit and the audit committee against the annual work plan, effectiveness of internal controls and additional measures that must be implemented to address risks, a summary of key issues dealt with, progress with any investigations and the outcomes, details of meetings and the number attended by each member, and other matters requested of the internal audit and AC. The audit committee is also required to prepare an annual report that will be incorporated in the annual report of the municipality and should cover the functions performed by the audit committee and meetings attended, resolutions taken by council and implementation status of recommendations made and other relevant comments that may enhance governance and accountability (National Treasury, 2012:8).

Roos (2017: 142-143) also recommends expanding on the information included in the audit committee report by adding to the statement on the effectiveness/non-effectiveness of internal controls and to include a description of the major control weaknesses and actions taken to address this. Roos (2017:142-143) proposes 13 additional areas to be included in the audit committee report.

The sections above describe the comprehensive roles and responsibilities of audit committees. But what are the consequences if audit committees do not fulfil their responsibilities? The next section briefly discusses liability and audit committees. Although it falls outside the scope of this research, it is still considered important to reflect on.

#### **4.19 Liability and audit committees**

According to Marx (2008:261), an audit committee member could be exposed to a higher level of potential legal liability and exposure as a result of the processes followed and the onerous



and increasing demands on audit committee members. Despite this, the audit committee members' legal position, including in local government, has received limited attention. Although Marx's (2008:261) research focus on the private sector, there are useful lessons for audit committees in local government to limit potential legal liability.

The responsibilities of the audit committee should be described in the audit committee charter. Audit committee members should be aware of their responsibilities stipulated in the charter and should not accept responsibilities delegated to them that fall outside that in the charter (Marx, 2008:260). Marx (2008) distinguishes between liability in terms of common law, statute, breach of contract and breach of corporate governance principles. Related to common law, Marx concludes that audit committee members might be exposed to a higher degree of potential legal liability as a result of their responsibilities and the expectations and trust placed in the audit committee members including that of the financial expert on the committee (2008:269). With reference to the MFMA (RSA, 2003) that describes the statutory duties of the AC, the Act does not provide for any penalty for non-compliance. Marx (2008:270) recognises that the audit committee serves as a sub-committee of the board and is accountable to the board and such a service should not imply a contractual relationship for audit committee members. However, related to corporate governance principles Marx states failure by audit committee members to act responsibly and diligently could result in disciplinary action or even dismissal in terms of the code of conduct (Marx, 2008:270-271).

Together with possible liability of the audit committee, it is necessary to examine what steps can be taken to limit the risk of potential legal liability. In her study on internal control failures and corporate governance structures, Goh (2007) studied the reputational penalties imposed on top individuals including top management, audit committee members and independent directors when monitoring of internal controls fail. She concludes that top management, audit committee members, and independent directors face reputational penalties when material weaknesses are detected. She found audit committee members experience higher turnover at firms where material weaknesses compared to the control firms (Goh 2007:4). During the fieldwork the ACCs that were interviewed all expressed the view to not want to be associated with a municipality that is not properly governed and where management or the council is not interested or prepared to listen to recommendations of the audit committee.

Marx (2008:272-275) recommends that audit committees should as a minimum display the following characteristics to limit the risk of legal liability: 1) the status should be defined and understood by all parties in that the audit committee is advisory and ultimate responsibility lies with the governing body, 2) existence of a charter, understood by all that sets out the status,

authority and responsibility of the AC. The charter should also provide for sufficient resources to enable the audit committee to discharge its responsibilities. 3) The composition of the audit committee should include diligent, conscientious members with the right mix of experience and expertise. 4) The audit committee should not accept responsibilities that fall outside their approved areas of responsibility and 5) meet regularly and receive an agenda with supporting documentation timeously. Accurate minutes should be kept of all proceedings. 6) The audit committee should meet and obtain input from all relevant parties and 7) regularly report to the governing body on tasks performed and responsibilities fulfilled (Marx, 2008:272-275).

Additional steps the audit committee members can take to limit their legal liability are to consider if they have the time, experience and expertise to fulfil their responsibilities and ensure that an approved audit committee charter exists and they are in agreement with it. Prospective audit committee members should also assess if the AC's mix of experience and expertise, specifically financial expertise is adequate before accepting an appointment. It is further required for audit committee members to properly prepare for meetings, attend all meetings and actively participate. Another recommendation by Marx is for audit committee members to take out additional insurance to cover the higher risk of potential legal liability (Marx, 2008:275-277).

Although applicable to the private sector, the IoDSA in the Business Judgement Rule also states a director should take reasonably diligent steps to be informed, not have a material personal financial interest, there must have been a rational basis for believing the decision was in the best interests of the company and ensure high-quality information with integrity that has been generated through a thorough process is provided (2013:3-8). In this regard, the audit committee places reliance on management and internal audit.

Provision is made for audit committees to seek advice to enable them to fulfil their roles and responsibilities. Audit committees should make use of this authority when considering the legal consequences of actions.

## **4.20 Conclusion**

This chapter includes a description of the different roles and responsibilities of the audit committee reflected in academic and professional literature with the focus on the responsibilities of audit committees in South African local government. Various sources including legislation, corporate governance codes, guidance documents, and audit committee

charters provide the basis for this chapter. The role of oversight versus advisory was unpacked and further explored and is also reported on as part of Chapter 7.

The extensive roles and responsibilities of the audit committee include areas such as financial reporting, internal audit, internal control, risk management, external audit, combined assurance, performance management, compliance, IT governance, ethics, and fraud. The medium the audit committee can use to demonstrate the fulfilment of its roles and responsibilities is the audit committee report, which is also discussed as part of this chapter. In his research on the effectiveness of audit committees in Victoria local government, Purcell (2012:68) warns against an overt regulatory approach to audit committee practices that can be an expensive use of resources. If too much time is taken up by compliance issues, less time is available for the audit committee to focus on broader issues including current risks, future council performance, and identification and management of new risks. The audit committee could struggle to prioritise, which could limit the AC's ability to concentrate on operational performance and non-financial outcomes.

## **CHAPTER FIVE: DETERMINANTS OF AN EFFECTIVE AUDIT COMMITTEE**

### **5.1 Introduction**

The objective of this chapter is to present the results of the research on the determinants of effective audit committees in local government informed by academic and professional literature and perceptions of other governance stakeholders. The study of different determinants of effective audit committees was necessary to be used in the analysis of those practice, practitioners, and praxis associated with effective audit committees in local government when compared with legislative and corporate governance and best practice requirements and governance stakeholders' perceptions.

The chapter starts by describing the challenges in measuring audit committee effectiveness. This is followed by a reflection on the factors considered necessary to enable the audit committee to fulfil its functions effectively. The remainder of the chapter presents the determinants of effectiveness including audit committee experience and expertise, composition and independence, authority, resources, diligence, audit committee remuneration and evaluation of the performance of audit committees.

### **5.2 Challenges in measuring audit committee effectiveness**

Regarding the challenges, Giles (1998) recognised the difficulty in measuring audit committee effectiveness directly. She refers to the different studies using proxies for effectiveness including the incidence of fraud or other illegal events (Beasley, 1996:443; McMullen, 1996:87), performance on an experimental task (DeZoort, 1998), the type and use of power by audit committees (Kalbers & Fogarty, 1993), and the quality of financial disclosures. Giles' study uses an indirect measure to determine audit committee effectiveness by analysing the quality of the firm's financial reporting measured by financial analysts (Kalbers & Fogarty, 1998:5). Spangler and Braiotta (1990:152) used subjective measures for effectiveness but acknowledge the problems with subjective measures include the unreliability of individual perceptual data, different interpretation and understanding of questions, and biased interpretation of performance by various parties due to self-serving attributions (1990:152). The literature review by Kalbers and Fogarty (1993:25-27) concludes that evidence of effectiveness is limited, measures for effectiveness are difficult to establish, and criteria are confined to those factors that can be quantified.

In her research on the role of audit committees, Spira (1999a:232) concurs with Giles (1998) regarding the difficulty of measuring effectiveness and questions whether effectiveness can only be meaningful if there is clarity on the purpose of audit committees. The answer provided in literature at the time was also unclear. In the 1980s, the purpose of audit committees was debated and the four main functions of audit committees identified, include the reduction of board liability, establishing a link between the external auditor and the board, reducing illegal activity, and prevention of fraudulent financial reporting. Based on her findings, Spira concludes that the concepts of audit committee effectiveness differ extensively between individuals and companies and that general instructions to achieve effectiveness might therefore be inappropriate (Spira, 1999a:236). During the fieldwork of this research, the view on effectiveness of audit committees was solicited and the different views are reflected in Chapter 7.

Purcell (2012:90-92) in his study reflect on criteria for effectiveness included in guidance documents summarised in Table 5.1. These criteria were also considered during compilation of determinants of effective audit committees presented in this chapter.

**Table 5.1: Purcell's summary of audit committee guides and criteria of effectiveness**

Institution	Effectiveness criteria
<b>Private sector</b>	
Hong Kong Society of Accountants - A Guide for Effective Audit Committees (2002)	Effective audit committees needed to: <ul style="list-style-type: none"> <li>- Clearly understand oversight role responsibilities.</li> <li>- Communicate independently with external and internal auditors.</li> <li>- Assess the quality of information and judgements presented from management.</li> <li>- Be suitably qualified and experienced.</li> </ul>
Institut Francais des Administrateurs - 100 Best Practices for Audit Committees (2008)	Audit committees should focus on: <ul style="list-style-type: none"> <li>- Quality of financial reporting.</li> <li>- Risk management and internal control systems.</li> <li>- Effective relationships with external auditors.</li> </ul>
KPMG Audit Committee Insights (2008)	View that efficiency and effectiveness could be improved by better prioritisation and more time to discuss issues and ask questions rather than listening to presentations from management.
<b>Public sector</b>	
IIA (2006)	<ul style="list-style-type: none"> <li>- Audit committees can strengthen independence, integrity, and effectiveness through independent oversight of internal and external audit plans.</li> <li>- Manage auditor's relationships with the entity.</li> </ul>
National Audit Office (2007) and HM Treasury	<ul style="list-style-type: none"> <li>- The role of the audit committee.</li> <li>- Membership.</li> <li>- Objectivity and independence.</li> <li>- Skills.</li> <li>- Scope of the audit committee and communications.</li> </ul>
Controller and Auditor-General New Zealand (2008)	<p>Questions centred on self-review.</p> <p>Assess the improvements the audit committee make to:</p> <ul style="list-style-type: none"> <li>- Policies and practices.</li> <li>- Risk environment.</li> <li>- Internal control environment.</li> <li>- Accountability model for non-financial results.</li> <li>- Strengthening of internal assurances.</li> </ul>
Auditor-General Manitoba (2006)	<p>Audit committee should review achievements against the following criteria:</p> <ul style="list-style-type: none"> <li>- Structures.</li> <li>- Oversight of financial reporting.</li> <li>- Relationships with auditors.</li> <li>- Compliance and regulatory environment.</li> </ul>

The next section include a discussion on factors required to enable audit committees to perform effectively.

### 5.3 Enabling factors for an effective audit committee

Various factors enable the audit committee to be effective and it needs resources to conduct their responsibilities effectively. This section describes the various factors that have been identified to enable the audit committee to fulfil its function effectively including support by various parties, the power of the audit committee (Cohen et al., 2004:102), and high-quality financial information (Wayne, 2003:17-18).

Regarding support, Kalbers and Fogarty (1993:29, 37) measured audit committee effectiveness and the link with support provided by the firm. Effectiveness was measured in terms of overall financial reporting, the annual audit, the external auditor and internal controls and the internal auditor. Support included the perceived timeliness, usefulness and reliability of information provided by senior management, including the internal auditor to the AC, the supportive attitude by top management, and the perceived working relationship between the audit committee and the chief executive officer, chief financial officer, chief internal auditor, and external auditors. They found that support is positively related to audit committee effectiveness. In their study on corporate governance and financial reporting quality, Cohen et al. (2004:102) recognise that the effectiveness of the audit committees not only depends on the knowledge and expertise in financial reporting but also the extent of support by the board.

Weiss (2005:85) concluded the research results provided mixed evidence on the contribution of firm-provided support. She found that audit committees that received support through training and sufficient information from management are more likely to constrain discretionary accruals. She recognised the paradox between the regulator's mandate to strengthen independence but at the same time the audit committee must rely on the institution to provide the necessary resources. Support and resources provided to the audit committee are one of the research areas during the fieldwork and are reflected on in Chapter 7.

Because the audit committee is a standing committee of the governing body, Rittenberg and Nair (1993:25) acknowledge that the audit committee derives its status and charter from the governing body and authority and power is limited to what is delegated to the audit committee by the governing body. The importance of the charter has been included as part of the

discussion during the fieldwork and is reflected on in Chapter 7. Kalbers and Fogarty (1993:24) studied the relationship between power and audit committee effectiveness. They found that organisational power, formal, written authority, and observable support from top management play the most important role in audit committee power. From a personal attributes point of view, diligence by the audit committee was the most important source of power (Kalbers & Fogarty, 1993:24). This was also confirmed during the fieldwork and reflected on in Chapter 7 where it was confirmed that power of the audit committee is contained in the charter approved by council but also to a large extent to the support provided by management to the AC.

According to Cohen et al., (2014:102) there is a need for the audit committee to be provided with real power by the board to enable effective monitoring of management actions. The audit committee and the auditors should be allies in the goal of achieving high-quality financial reporting and prevention of fraud.

The following sections describe the various determinants of effectiveness in more detail including audit committee experience and expertise, composition and independence, authority, resources, diligence, remuneration, and performance evaluation. Annexure 2 provides a summary of the different components of effectiveness based on the literature review.

#### **5.4 Audit committee experience and expertise**

This section reflects on the reasons for the requirement that audit committees have the necessary experience and expertise and the recommended areas in which audit committees should have experience and expertise.

The need for audit committee members to have the necessary experience and expertise as a determinant of effectiveness has been a consistent theme in the literature on audit committee effectiveness. Audit committee members themselves also recognised the need for having a sufficient level of expertise relating to technical accounting issues and technical audit issues (DeZoort, 1997:208; 1998:1). The literature review completed by DeZoort et al. (2002:47, 224) refers to studies that focussed on the audit committee members' perceptions of their own expertise and found audit committee members believed that all audit committee members should have expertise in the oversight areas of financial statement review, auditing, and law.



DeZoort et al. (2002:47) refer to a variety of literature and research on audit committee member expertise and experience and the importance thereof as a criterion for effectiveness.<sup>60</sup> A theme that emerged from the synthesis of audit committee literature by DeZoort et al. (2002:51) concluded that audit committee experience/expertise is perceived to be a critical component of effectiveness. Audit committee experience/expertise, based on the research, is linked to greater interaction with internal auditors, reduced incidence of financial reporting problems, and greater support for auditors in auditor-management disagreements.

However, despite the importance of experience and expertise, the results of the early research by DeZoort et al. indicated a great discrepancy of experience and expertise within and among audit committees and the researchers concluded many audit committees lack adequate experience and expertise. Over and above the importance of technical accounting and auditing experience the importance of audit committee members having industry knowledge was also identified as critical (Giles, 1998: ii; Lee & Stone, 1997).

The motivation or reasons for audit committee members to have the required experience and expertise have been substantiated by different research projects. Through experimental research, rather than survey and archival studies, DeZoort, Hermanson and Houston (2008:1) evaluated how general and task-specific experience impact the internal control judgement of audit committee members. The results showed that audit committee members with experience made internal control judgements more like auditors when compared to members without experience. DeZoort et al. (2008:1) also found prior work experience had a positive impact on the oversight by audit committees. During the fieldwork, participants alluded to the benefits brought about by audit committee members also serving on other audit committees.

DeZoort and Salterio (2001:31) concluded that the accounting and auditing knowledge of audit committee members affected their judgements about the substance of issues in an auditor-management dispute about an accounting policy issue. They found increased audit knowledge resulted in higher audit committee member support for the auditor in the dispute with management whereas concurrent experience as a board director and management was associated with increased support for management. This supports the notion that different levels of knowledge could lead to differences in audit committee member judgements during disputes between auditors and management (DeZoort & Salterio, 2001:31). Davies (2009:60) examined the working relationship between audit committees and chief internal auditors in 22

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<sup>60</sup> 12 studies are referred to in the article including, *inter alia*: Archambeault and DeZoort (2001); Beasley and Salterio (2001); Kalbers (1992a, 1992b); Lee and Stone (1997); and McMullen and Raghunandan (1996).

councils in Wales in 2008 from the perspective of the chief internal auditors. She indicated the need for audit committees to have an increased understanding of auditing and accounting matters.

Recommended areas in which experience and expertise are required include financial expertise, industry knowledge, and organisational experience.

The necessity for industry (municipal) and organisational experience and expertise have been recognised in research and during the fieldwork of this research. West and Berman (2003:334) recognise the need to select audit committee members that are knowledgeable about the organisational context. Weiss (2005:7) concludes her study by providing evidence that financial expertise acquired through in-depth knowledge of the firm's financial operations and not acquired through occupation contributes to monitoring effectiveness. The AGA's (2008) research paper recognises that audit committee members acknowledge they do not have enough information about the activities and operations of the organisations they serve. The AGA (2008:5) states the need for orientation and education when responsibilities are assumed and for ongoing education of the members on the activities of the entities and on professional development. The IIA (2014:10) acknowledge that the key to the effectiveness of audit committees is having members with the appropriate mix of skills and experience relevant to the organisation's responsibilities. One way in which audit committee members' knowledge of the organisation can be obtained is through thorough induction training. The need for local government knowledge was a theme that was consistently highlighted during the fieldwork and is further discussed in Chapter 7 together with the need for professional development of audit committees.

Numerous studies have reflected on financial literacy/financial expertise and audit committee effectiveness with mixed results (Abbott et al., 2004:69; DeZoort, 1997:224; DeZoort et al., 2002:42; Dhaliwal et al., 2010:820; Goh, 2009:550; Kalbers & Fogarty, 1993:37; McMullen & Raghunandan, 1996:81; Reidenbach, 2013:5; Turley & Zaman, 2004:326; Wayne, 2003: 36; West & Berman 2003:334). Beasley et al. (1999:2) found that most audit committees in companies experiencing fraud did not have accounting or finance certification or experience. The importance of financial literacy was recognised by the BRC in that it was required that audit committees comprised of a minimum of three financially literate directors of which at least one member has accounting or related financial management expertise (Beasley,

1999:1073).<sup>61</sup> Goh (2009:550) found firms with a lower proportion of audit committee members with non-accounting financial expertise,<sup>62</sup> smaller audit committees, and a lower proportion of independent board members are more likely to be related to the incidence of material weaknesses.

McDaniel, Martin, and Maines (2002:139) studied the effects of financial expertise versus financial literacy on the audit committees' judgement of financial reporting quality. They found that a financial expert was able to identify shortcomings in financial reporting that were not that obvious or publicised whereas the audit committee member that was financially literate was unable. They also found financially literate audit committee members focused more on non-recurring financial information while the financial expert focussed more on recurring financial information. The conclusion by DeZoort et al. (2002:51) is similar and found that financial experts tend to focus more on recurring, less-prominent issues while financially literate members focussed more on nonrecurring prominent issues. The authors conclude that efforts to enhance audit committee financial expertise may influence audit committees' assessments of financial reporting quality. West and Berman (2003:334) also refer to the need for audit committee members to be experienced in financial reporting and auditing.

Marx (2008:55) states:

"An audit committee will be effective only if it has the right characteristics. For this reason an effectively functioning audit committee can be described as a committee that is properly constituted, consists of members with an impartial state of mind ('independence') who have the right mix of experience and expertise and whose role and responsibilities are clearly understood and supported by the board. The modern audit committee will be of value only if it is properly constituted, is functioning effectively and if its role is clearly understood by all parties concerned."

Marx (2008:49) distinguishes between financial literacy, financial experience, and financial expertise and concludes that due to audit committees dealing with financial reporting, auditing and control-related issues the members need to have an understanding of accounting and

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<sup>61</sup> Expertise was defined as having work experience in finance or accounting, professional certification in accounting or other comparable experience resulting in financial cleverness including being a CEO or other senior officer with financial oversight responsibilities.

The Securities Exchange Commission defines a financial expert as an individual who understands financial statements and generally accepted accounting principles. Such an expert must have a comprehensive understanding of internal controls and procedures for financial reporting and understand the roles and responsibilities of the AC. The expertise could be acquired through education and experience (SEC 2003).

<sup>62</sup> Non-accounting financial expertise includes, for example, expertise gained through experience supervising employees with financial responsibilities and overseeing the performance of companies while accounting financial expertise refer to experience gained through accounting-related experience in Securities Exchange reporting (Goh, 2009:551).

auditing concepts and different requirements for audit committees to be financially literate or have financial experience and expertise are prescribed by different codes.

Singhvi (2011:5) refined the research further by distinguishing between different groups of experts, i.e. an *Audit/CPA*<sup>63</sup> expert, *Accounting/Finance*<sup>64</sup> expert, or *Other*<sup>65</sup> experts. She found when an *Audit/CPA* expert is hired, there is a significant positive market reaction at 10% although the director appointed is not a designated audit committee financial expert. She also found a positive market reaction of 3% where firms had four or more audit committee financial experts present after the new appointment. The market therefore views a team of audit committee financial experts positively (Singhvi, 2011:6). She also found that when audit committee accounting expert directors depart the market reacts negatively indicating accounting experts are valued by the market. She found that directors with *Audit/CPA* and *Accounting/Finance* were in high demand and most firms continue to add more and more financial experts to their audit committee. She also found an increase in the number of audit committee meetings (Singhvi, 2011:8).

This study did not distinguish between financial expertise and financial literacy in assessing the composition of audit committees. However, during the fieldwork, discussed in Chapter 7, some participants indicated that members of audit committees with financial expertise, for example chartered accountants, tend to dominate the composition of the relevant audit committee and there is room to introduce other experience and expertise for example knowledge of local government, information technology and risk management.

Giles (1998:30) in her study on the relationship between audit committee characteristics, including competence and quality of financial reporting, she referred to work histories, education and professional certifications or designations to be reflective of competence. She finds no significant relationship between higher levels of competence and higher quality financial reporting. However, the findings suggest firms with higher quality financial reporting have audit committees with more experienced members either as chief executive officer or as a board member elsewhere. Giles (1998:30) also reported, based on survey results that audit committee members feel that at least one member need to possess expertise in financial reporting and auditing. Williams (2005:265) found that most companies had more than one

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<sup>63</sup> CPA stands for certified public accountant, and, in this category, experts had to be a CPA or an audit manager or partner with an auditing firm.

<sup>64</sup> Under this category, the expert had to have prior experience as a chief financial officer, treasurer, or vice-president of finance.

<sup>65</sup> Other experts included all those AC members that were classified as financial experts by the Company. Under section 407 of SOX firms are required to disclose in the proxy statement the name of the AC financial expert (Singhvi 2011:5).

financial expert on their audit committee. Davidson, Xie and Xu (2004:279) and DeFond et al. (2005:153) also found a positive market reaction when financial accounting experts were appointed to audit committees. Raghunandan et al. (2001:116) reported that the CAEs indicate that companies where the audit committees complied with independence and had at least one member with accounting or finance background had longer meetings, more private meetings and reviewed the work of internal auditors more than those who did not comply with these requirements.

Other areas of required expertise and experience include governance, assurance, internal control evaluation, risk management, laws, and regulations, and proficiency in interpersonal communication (West & Berman, 2003:334).

DeZoort (1998:1) found performance of audit committee members with auditing and internal control evaluation experience were higher in the areas of judgement, self-insight, and consensus than those without experience and made judgements like experts (auditors) in the areas. He concluded that general domain and task-specific experience made a significant difference in audit committees' internal control and audit committee member's work experience made a difference in the oversight functions of audit committees. Magrane and Malthus (2010:436) refer to the collective need for financial expertise, knowledge of governance, assurance, risk management best practice, knowledge of the sector and other business acumen deemed appropriate, based on the guidelines by the Office of the Auditor-General Wellington.

The IIA (2014:5, 13) indicate audit committee members should collectively be knowledgeable about or have expertise in finance and accounting, business, auditing, risk management, compliance and information technology (2014:5) and per leading practice have at least one person that is a financial expert.

Martinov-Bennie, Soh and Tweedie (2015:748) state that while financial expertise was to be of particular importance to governance role-players, what emerged from their study was the right balance within an audit committee with a mix of expertise and a chairperson who is capable to establish and maintain group dynamic including different contributions and conflict.

The King IV (2016:56) requires that members of the audit committee, as a whole, have the necessary financial literacy, skills, and experience to execute their duties effectively.

This section reflected on the various skills and expertise required for effective audit committees. The next section discusses the audit committee composition and the need for an independent audit committee.

## 5.5 Audit committees' composition and independence

Over and above the need for the audit committee to have the required experience and expertise, discussed in the previous section, another significant area of research on the effectiveness of audit committees is the composition of the audit committee. Various researchers concluded the composition of audit committees impacts significantly on their ability to perform their duties and activities effectively (Abbott et al., 2003; 2004; Bédard et al., 2004, Carcello & Neal, 2000, 2003a, Chen et al., 2005, Chien 2007, Felo et al., 2003, Klein, 2002a, Krishnan, 2005, Lee, Mande & Ortman, 2004, McMullen & Raghunandan 1996, Purcell 2012, Raghunandan et al., 2001, Scarbrough et al., 1998, Uzun et al., 2004:42 and Xie et al., 2003). Research on composition mainly focuses on size, independence, and financial expertise.

The need for independence<sup>66</sup> to enhance effectiveness has been recognised throughout the research on audit committees and is one of the most common variables in the audit committee composition research literature (Abbott et al., 2000:55, Beasley, 1996:443, Carcello & Neal, 2003a:289, Carcello & Neal, 2003b:95, DeZoort et al., 2002:45,<sup>67</sup> DeZoort & Salterio, 2001:34, Liu, 2005:50, McMullen & Raghunandan, 1996, Scarbrough et al., 1998, Vicknair et al., 1993).

Cohen et al. (2004:102), in their study on corporate governance and financial reporting quality, recognise audit committee's independence is a key factor to enable audit committees to confront management.

Richardson and Baril (2003:36) stated that 'independence, in fact, requires the audit committee members' judgements are not tainted by their interests in management or the auditor. Independence 'in appearance' demands that a reasonable person with knowledge of the interests of the audit committee member would conclude that the member is objective'. Members of the audit committee are considered to be independent if they have no

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<sup>66</sup> Independent AC members are defined by the IIA as a person who is not employed by or providing any services to the organisation other than the duties as an audit committee member (IIA, 2014:12).

<sup>67</sup> In the DeZoort et al.'s (2002:48-50) synthesis of audit committee literature, they identify 15 composition studies on the audit committee member independence.

relationship<sup>68</sup> to the entity that might interfere with exercising independence from management or the organisation (Braiotta et al., 2010:17).

Weiss (2005:85) concludes that independence, if defined according to some of these descriptions, will not necessarily ensure monitoring effectiveness by the audit committee. Her study finds the audit committee must act independently.

The meaning of independence with reference to director-management relationships or the so-called grey area director/member was also researched. Vicknair et al. (1993:55) highlight the potential grey area director/member issue in which it was found that 74% of the audit committees in the sample had at least one grey area director. Giles (1998:36) describes a grey area director as:

“One who on the face of things looks to be independent because he or she is not currently employed by the firm on whose board he or she serves as a director. However upon closer inspection, it will be discovered that this director has a relationship that has the potential to impair his/her independence, such as interlocking directorates; directors who have business ventures with the firm or members of its management; executives or directors of major suppliers or customers of the firm; directors who are affiliated with the firm’s investment bankers or commercial bankers; lawyers receiving fee income; retirees of the firm; consultants to the firm; and relatives of management.”

Carcello and Neal (2000:454) describe grey directors to include relatives of management, professional advisors to the company, significant suppliers or customers of the company, or former officers or employees of the company or a related entity. They found that companies that received going-concern reports have on average a smaller percentage of grey directors on the audit committee which is to be expected in that the audit committee will support the auditor in negotiations over the type of report to be issued.

The independence of audit committee members has been associated with financial statement quality, fraudulent financial reporting, or the quality of earnings (Abbott et al., 2000:55, Abbott et al., 2004:69, Beasley et al., 2000:441, DeZoort et al., 2002:51, Klein, 2002b:375, Liu, 2005:50; Nashwa, 2005:42; Wayne, 2003:37 and Uzun et al., 2004:42), the audit function,<sup>69</sup>

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<sup>68</sup> Examples of relationships include being a director employed by the corporation; receiving compensation other than for board services; being a member of the immediate family of an individual that has been in the past five years been employed by the corporation; being a partner in a for profit business from which the corporation receive payments that are significant; a director employed as executive of another company where any of the directors serve on that company’s compensation committee (Braiotta et al., 2010:17).

<sup>69</sup> Abbott and Parker (2000); Archambeault and DeZoort (2001); Carcello and Neal (2000); Raghunandan et al. (2001); Scarbrough et al. (1998).



and governance and company variables (Beasley & Salterio, 2001:539; Klein, 2002a:436). The research by Abbott et al. (2004:69) found significant negative associations between the occurrence of restatement of financial information and audit committee independence and audit committees including at least one member with financial expertise.<sup>70</sup> Other associations with independence include support for external auditors (DeZoort & Salterio, 2001:31, Carcello & Neal, 2003b:113, Lee et al., 2004:143), and audit committees appointing higher quality external auditors and interacting more with internal auditors (DeZoort et al., 2002:51). Members of the audit committee without economic or psychological ties would also be more likely to question management (Carcello & Neal, 2000:465). Chien (2007:66-67) concludes in his study on audit committees in the public sector (public hospitals) that audit committee independence, financial expertise, and activity level (meeting frequency) have a positive effect on internal control quality for hospitals. Bédard and Gendron (2010:191) also summarised the literature on the association between audit committee characteristics such as composition and resources and internal control, one of the four<sup>71</sup> areas examined. Overall, the examination indicates a positive association between audit committee independence and effectiveness.

In their research on the processes of audit committees, Beasley et al. (2009:109) found that ACCs are more likely to have personal connections with directors or executives before joining the board and are more recent participants in the audit committee world. In their findings they state the following:

“It appears in many organizations, the strategy for selecting an audit committee chair is to approach an accounting expert who is well known by someone on the board or in management. Interestingly, the audit committee chairs serve on committees that appear somewhat less focused on having the audit committee directly involved in assessing the risk of fraudulent financial reporting” (Beasley et al., 2009:109).

As part of the process to identify members to serve on the audit committees, Beasley et al. (2009:81) found many members were identified because of their previous contact with management or other directors that could place doubt on the independence of audit committees.

During the fieldwork, it was also identified that in cases where an appropriate audit committee member could not be obtained through the advertisement process, head-hunting took place

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<sup>70</sup> Restatements indicate recognition of a material omission or misstatements in prior financial statements, questioning the quality of financial information (Abbott et al., 2004:69).

<sup>71</sup> The other three areas being financial reporting, external auditing, and investor's perception (Bédard & Gendron, 2010:199).

and members approached that had the necessary skills and competencies. At some of the municipalities, it was also acknowledged that the ACC and the MM, for example, 'grew up together'. However, this was not considered a 'hindrance' in terms of independence but rather contributing to frank and open discussions taking place between the ACC and MM.

The BRC (1999) issued ten recommendations to improve the audit committee function in publicly held companies, of which two were aimed at strengthening the independence of the audit committees (Braiotta et al., 2010:17).

The IODSA (2016) identified one of the highlights of the King IV is to address the balanced composition of governing bodies and independence. The King IV recognises the need to have members of the governing body that is independent but then contextualise the relevance of independence by stating all members of the governing body, whether executive or non-executive, have as a matter of law; a duty to act with independence of mind in the best interest of the organisation. Furthermore, independence in appearance is but one consideration in achieving balance in the composition of the governing body. The overriding concern is whether the governing body is knowledgeable, skilled, experienced, diverse, and independent enough to discharge fully its governance role and responsibilities (IODSA, 2016:28). Related to the AC, the King IV requires that all audit committee members, including the chairperson be an independent, non-executive member of the governing body (IODSA, 2016:56).

Similar findings were made by Martinov-Bennie et al. (2015:748) in that key governance actors perceive the audit committee members' experience and expertise to be more important than formal independence.

In the local government context in South Africa, it is a legislative requirement that audit committees cannot be in the employment of the municipality. The importance of independent audit committees is also recognised in the guideline document circular 65, applicable to local government that recommends the audit committee should be independent and safeguarded from undue influence. According to the circular, the audit committee should demonstrate independence of mental attitude during deliberations and declare private and business interest in every meeting. Audit committee members should also not carry out any business with the municipality. To enhance independence, the circular also prescribes the term of office where members should serve a minimum of three years but should not be contracted continuously for a period exceeding six years (National Treasury, 2012:26). It is acknowledged that the appointment process could impact independence. As part of the fieldwork, the audit committee appointment process was discussed with the participants and is included in Chapter 7.

The last two sections discussed the determinants of effective audit committees related to experience and expertise and composition and independence. However, one of the challenges identified during the fieldwork is the availability of eligible members, particularly at smaller and remote municipalities. The challenge is not unique to South Africa. Davies (2009:46) also alludes to the difficulty in obtaining audit committee members at especially small municipalities in Wales - "Identifying sufficient members with appropriate skills and experience can be difficult, especially as many such members could already be serving on other committees and thus may not be eligible for membership". Circular 65 on audit committees also suggest that members should not serve on more than three municipalities and restricts the tenure to six years, making the pool of available audit committee members even lower at smaller and remote municipalities. This has been identified as a major obstacle in accessing audit committee members with the necessary skills and experience.

The next section explores the impact of audit committee authority on the effectiveness of audit committees.

## 5.6 Audit committee authority

One of the four components that may contribute to audit committee effectiveness identified by DeZoort et al. (2002:42), in their synthesis of audit committee literature, is authority. Several studies in the area of authority of audit committees are highlighted by the researchers.<sup>72</sup> Kalbers and Fogarty (1993:25) examine the types and extent of audit committee power that plays a role in effectiveness of audit committees. They find that expert power (perceived level of knowledge) was significantly related to the effectiveness of audit committees in their oversight of financial reporting. Kalbers and Fogarty (1993:44) considered power to include the perceived level of knowledge of the audit committee about accounting, auditing, financial controls, and systems and about the company and industry in which it operates. They state that audit committee power within the organisation comes from a combination of written authority and the clear support by management (Kalbers & Fogarty, 1993:45). The importance of the knowledge of audit committee members about the local government environment and oversight areas in establishing authority has also been recognised by various participants during the fieldwork.

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<sup>72</sup> Eight authority studies are referred to by DeZoort et al. (2002: 56-57).

Turley and Zaman (2007:770) observe that authority can be created through activities outside the formal audit committee context and could be influenced by individual power demonstrated by the ACC. Factors affecting power include respect, values and leadership qualities of the audit committee members and chair and the perceived preparation, vigilance, independence, and the levels of activity of the audit committee members and chair. Financial expertise and personalities that can influence, interests of different functional areas, relationships between management and the rest of the organisation and between management and external auditors could also influence the effect of audit committees on power relationships (2007:770).

Spangler and Braiotta (1990:136) confirm the importance of leadership in their reflection on the effectiveness of audit committees from the contemporary leadership theory perspective. They recognise the importance of the leadership behaviour of the chairperson. The critical role of the ACC in effective audit committee have also been confirmed in other research and was confirmed by participants in the field studies, further reflected on in Chapter 7.

Hardiman (2006:51) identified the following required experience and skills: knowledge of the entity, its environment and constituency, accounting, auditing and financial reporting, effective interpersonal and communication skills, and understanding and appreciating management's responsibility to establish and monitor internal controls. He further identified the need for audit committees to be 'tough-minded' and be willing to ask hard, penetrating questions and deal with controversial matters constructively. During the interviews, the need for audit committees to ask interrogating questions was also identified as a critical aspect of effective audit committees.

Closely related to authority is the relationship with management, and Magrane and Malthus (2010:427) found that the 'informal networks' between management and the audit committee can strengthen the effectiveness of the audit committee. Other proponents of oversight through informal processes are Beasley et al., (2009:113), Gendron and Bédard, (2006:230), Turley and Zaman, (2007:782), and Zain and Subramaniam (2007:894). The research by Zaman and Sarens (2013:495) provides empirical evidence on the influence of the AC, the ACC, the internal audit function, and the CAE's characteristics on the informal interactions. The research also finds that the knowledge and experience of the ACC in diverse areas<sup>73</sup> have a positive association with the existence of informal interactions between audit committees and the internal audit function. Another positive association is found between the existence of

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<sup>73</sup> Areas include knowledge of business, business-specific risks, corporate governance, risk management, internal control, accounting and finance, and internal and external auditing (Zaman & Sarens, 2013:500).

informal interactions and the quality of the internal audit function (Zaman & Sarens, 2013:497). The fieldwork showed a mixed application of informal interactions and practices at the sample of municipalities that formed part of the fieldwork, further discussed in Chapter 7.

The next section discusses the third element of audit committee effectiveness identified by DeZoort et al. (2002:43), namely, audit committee resources.

## 5.7 Audit committee resources

DeZoort et al. (2002:44), in their description of the resource component of effective audit committees, emphasise that for effective oversight, the audit committee needs to have adequate resources. Resources include a sufficient number of audit committee members to generate substantive discussion and consider emerging issues and access to management, external auditors, internal auditors, the full board, and legal counsel.

Initial research projects on the resource component of effective audit committees focussed mostly on support from external and internal audit and the size of the audit committee (DeZoort et al., 2002:58). Felo et al. (2003:1), in their analysis on the association between audit committee characteristics and quality of financial reporting, found that audit committee members with expertise in accounting or financial management and the size of the audit committee (larger audit committees) are positively related to financial reporting quality. The BRC (1999:1073) requires all listed companies to have a minimum of three financially literate members on the audit committee (and most of the recommendations related to the size of the audit committee suggest between three and five members (Chien, 2007:18).

Effective audit committees also need to have access to other corporate governance groups as identified by DeZoort et al. (2002:44) and recognised in local government, South Africa by the PSACF. The PSACF has issued discussion documents on the relationship between the public sector audit committee and management and between the audit committee and council (IODSA, 2014d; 2014e).

West and Berman (2003:347), in their study on local government audit committees, also studied support to the audit committees by various role-players including the MM, elected officials, government, citizens, and local business. Related to supporting the AC, the greatest support was found to be from city managers or chief accounting officers, followed by the

elected officials or council. Weak support was provided by public managers and citizens and local business leaders.

Various practices of interactions between the audit committee and management and the council have been identified during the fieldwork and are further analysed in Chapter 7.

Another important resource for effective audit committees is access to accurate, timely, and complete information from managers and auditors (DeZoort et al., 2002:45). DeZoort et al. (2002:67), recognise that limited research in this area has been performed.

The AC, usually provided for in the audit committee charter, can supplement their resources by making use of outside advisors if so required. Based on the experience of the researcher serving on audit committees, the option to use outside advisors is not utilised by audit committees. One of the contributing factors could be the associated cost that municipalities will have to carry, and the limited funds municipalities have available. Another reason could be that the audit committees have not considered it to be necessary. The reasons for the apparent lack of using outside advisors did not form part of the scope of this study and could be an area of future research. DeZoort et al. (2002:67) also identified the need for a study on the extent to which outside advisors are used by audit committees, the types of support provided, and whether there is a causal link between effective audit committees and advisor usage.

Time is another important resource for audit committee members. Audit committee members need time to thoroughly prepare for audit committee meetings, have enough time to conduct effective meetings, and have time available for informal interactions with internal audit and management. Rittenberg and Nair (1993: xiii) solicited the opinions of audit committee members, audit partners, and internal audit, all of whom believed sufficient meeting time was an important factor in audit committee members' ability to function effectively.

Giles (1998:41) also recognises the need for an audit committee member to have time available but emphasises that audit committee members must also be willing to devote the necessary time. Time-related factors, other than attendance of meetings and preparation time, referred to by Giles (1998) also include the number of meetings attended, total number of outside directorships held, and respective committee assignments and current job requirements. In her thesis, she uses the number of outside directorships and whether the audit committee member is employed as the chief executive officer of another institution to measure time availability (Giles, 1998:41).

According to Zheng (2008:1), time availability and the impact of multiple directorships is a contentious issue in both practice and academia. On the one hand, there is a concern that having multiple directorships could result in directors being too busy to perform their functions effectively and she proposes limiting the number of directorships held by individuals to not more than two (Council of Institutional Investors, 2002:5, NACD governance guidelines, 2017:9). On the other hand, some companies consider that having multiple directorships improves governance effectiveness (Zheng, 2008:2). Various academic studies have been completed on the consequences of multiple directorships. Empirical findings on prior literature also provide mixed results. The studies that argue that multiple directorships are associated with ineffective monitoring of management due to insufficient time and commitment was completed by Core, Holthausen and Larcker (1999:383), Shivdasani and Yermack (1999:1847) and Fich and Shivdasani (2006:689). The other group that argue having multiple directorships is beneficial to shareholders include Fama and Jensen (1983:314), Kaplan and Reishus (1990:389), Coles and Hoi (2003:229), and Harris and Shimizu (2004:775). They argue that the labour market for directors can serve as a disciplining mechanism incentivising them to be diligent in performing their monitoring functions and having multiple directorships provides directors with experience, knowledge, and best practice from other firms. Carcello and Neal (2003b:113) use multiple directorships as one characteristic of an effective AC.

Core et al. (1999: 383, 388) not only discussed 'busy directors' but also reflected on the age of directors, arguing for mandatory retirement ages and term limits and find directors may become less effective as they grow older and serve on too many boards. Busy directors served on three or more corporate boards and six or more if the director is retired.

Because audit committees are one of the busiest sub-committees of the board, serving on multiple audit committees could impact the effectiveness of audit committees. Zheng (2003:3) examines multiple directorships at the audit committee level and whether it can be associated with effectiveness represented by a firm's financial reporting quality. He focusses on the audit committee as a whole and key members of the audit committee being the ACC and the financial experts. Zheng (2008:6) did not find a significant association between audit committee multiple directorship and financial reporting quality at the audit committee level. However, he found a significantly positive association between high multiple directorships of ACCs or audit committee financial experts and financial reporting quality, specifically where the chairs were also financial experts.



Related to time is the issue of the tenure of audit committee appointments. There are two schools of thought: the advocates for long tenure believe that serving for a long period results in a more knowledgeable and valued member as a result of firm-specific knowledge and less dependence on management as a source of information (Park, 1998:34; Hermalin & Weisbach 1988:105), while the other group believes rotation is required to have new inputs. Singhvi (2011:6) also finds a significant negative reaction when a short tenure (0-3 years) and medium tenure departs from the AC.

In South Africa, the legislation related to local government is not prescriptive about the number of audit committees on which members can serve nor the tenure. However, Circular 65 requires of the council to ensure audit committee members do not serve on more than three local government audit committees simultaneously as it could impact on audit committee effectiveness (National Treasury, 2012:5-6). The circular also encourages the rotation of members and recommends members should not be serving for a period of longer than six years. This restriction poses a challenge for small and remote municipalities in the endeavour to recruit competent people to serve on audit committees as it restricts the pool of expertise available. Time availability was further explored during the fieldwork and mixed views and results were observed. This is further discussed in Chapter 7. The next section discusses audit committee diligence as one of the determinants of effective audit committees.

According to DeZoort et al. (2002:42):

“An effective audit committee has qualified members with the authority and resources to protect stakeholder interests by ensuring reliable financial reporting, internal controls, and risk management through its diligent oversight efforts.”

According to DeZoort et al. (2002:44), audit committee authority depends on the relationships with management, external and internal auditors, and the board, or council in the case of municipalities. Diligence refers to the willingness of committee members to work together when required, attend meetings well-prepared, and ask questions and pursue answers from management, external and internal auditors, and other parties. Diligence can also include audit committee members being active, interested, and meeting frequently (DeZoort et al., 2002:42; Purcell, 2012:70). The next section describes audit committee diligence.

## 5.8 Audit committee diligence

Research has shown that audit committee diligence is a significant factor that influences the effective functioning of audit committees. The BRC (1999:1093) principle 5 states the governing body 'should have mechanisms that encourage selection and retention of diligent and knowledgeable members who are dedicated to and interested in the job and willing to devote a substantial commitment of time and energy to the responsibilities of the audit committee ...'. DeZoort et al. (2002:45) describe diligence as: 'the willingness of committee members to work together as needed to prepare, ask questions, and pursue answers when dealing with management, external auditors, internal auditors, and other relevant constituents'.

This section explores the research on audit committee diligence including possible measures of diligence and factors impacting on diligence.

DeZoort et al. (2002:59), in the summary of the literature on audit committee effectiveness, recognise the difficulty in measuring diligence as evident by limited and narrowly focussed research on this component of effectiveness.<sup>74</sup> The focus is mostly limited to the number of audit committee meetings per year, and to a limited extent, voluntary audit committee disclosures. According to Raghunandan and Rama (2007:265), the number of audit committee meetings is mostly used by researchers as a proxy for audit committee diligence due to it being a publicly quantifiable signal. DeZoort et al. (2002:65) conclude that audit committee diligence literature demonstrates the importance of having an adequate number of audit committee meetings per year. More meetings are associated with reduced financial reporting incidents and better external audit quality. The need for further research on audit committee member motivation including for example audit committee stock ownership, the impact of penalties for poor audit committee performance, other forms of accountability like justification and feed-back, and member compensation is encouraged by the researchers.

McMullen and Raghunandan (1996:81) found that more frequent audit committee meetings are associated with a reduced probability of financial reporting problems and regular meetings with internal audit result in audit committees being informed and knowledgeable about relevant accounting issues. Collier and Gregory (1999:311) used the number and duration of meetings to measure audit committee activity. The notion is that active audit committees, as measured by the number of meetings, would improve monitoring, and thereby improve the quality of the

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<sup>74</sup> The researchers refer to 10 studies on diligence as part of the synthesis (2002:63-64).

entity's financial reporting (Raghunandan & Rama, 2007:265). Beasley et al. (2000:441) found audit committees of fraud companies met less often than the audit committees of those companies where fraud was not reported. Stewart and Munro (2007:54) found that auditors perceive the audit risk is reduced with audit committee meeting frequency. Goh (2007:54) used the number of times the audit committee meets in a fiscal year to measure the diligence. The number of meetings are important considering the important role of the audit committee and enables continuous review of controls (Seawright, 2015:8). Singhvi (2011:36) identifies the frequency of meetings as a measurement for the diligence of audit committees. According to her, frequent meetings provide for better communication between audit committees and others such as external and internal auditors.

Zaman and Sarens (2013, 508) indicate that independent audit committees are more active in its approach to internal audit. More active committees are likely to encounter greater information needs and are more likely to be more interested in interacting with the internal audit function.

Raghunandan and Rama (2007:267) expanded the scope of research related to measuring audit committee diligence through the number of meetings by examining the association between firms' characteristics and the number of audit committee meetings at 319 firms. They found that the frequency of audit committee meetings is higher for larger firms, firms that are in industries that are prone to litigation, and firms that have more board meetings. The link between having more board meetings and audit committee frequency could reflect the board's diligence rubbing off on the AC. Their research also found the number of audit committee meetings is higher when there are more members on the committee. The reasons could be that more perspectives need to be considered or more people be convinced resulting in more time needed for meetings. In South African local government, the link between the number of members and the number of meetings is less relevant due to the size of the audit committee being between three and four members. Limitations of the study by Raghunandan and Rama include (2007:277) the fact that frequency is not necessarily a perfect proxy for audit committee diligence as it does not measure the quality of the monitoring or oversight by the audit committee nor the duration of the meetings or the nature of the interactions.

As part of the research to understand what the audit committee members do during their interactions, Spira (2003:180) investigated the content and context of the questioning process as part of the audit committee activity. However, due to the lack of research information on how the audit committee does its work, mainly as a result of limited access to meetings and meeting documentation, it is necessary to also refer to literature provided by professional

bodies, consultancies, and accounting firms. Literature disseminated by these parties provide practical advice on how activities should be performed based on 'best practice', although the criteria on which the judgement of best practice is based is not necessarily provided. The emphasis of many of the publications, according to Spira (2003:183), is on the asking of questions by audit committee members. However, the role of the audit committee is limited due to audit committees not having the necessary authority, questions can be asked but they cannot do much about the answers given (Spira, 2003:185). During the fieldwork, some participants identified the challenge that audit committees can ask interrogating questions and make recommendations but have no authority or power to enforce actions. Asking questions is important to obtain information, explanations, and confirmations but could also be a display to demonstrate the qualities of the person asking the questions and the person providing the answers. Questions asked by the audit committee could also provide them with an opportunity to demonstrate their independence and the formal recording in the minutes of the meeting can also serve as a protective measure where the effectiveness or diligence of the audit committee is challenged (Spira 2003:186). Spira (2003:187) concludes by recognising asking of questions is a significant tool that can be used by audit committees but the process is constrained by boardroom culture and logistics that can eventually lead to it remaining a symbolic performance rather than a substantive contribution to improving the quality of the information. In the research by Beasley et al. (2009:107), the respondents also indicated that the single most important activity of the audit committee is to ask good questions, which is confirmed in the research by Gendron et al. (2004:153). The asking of interrogating questions formed part of the fieldwork study and is reflected on in Chapter 7. The fieldwork results, access to meeting documentation and the practical experience of the researcher in attending audit committee meetings, to some extent countered the lack of research information on how the audit committee meetings work identified by Spira (2003).

Other proxies for diligence were used in a few published studies referred to by DeZoort et al. (2002:62) including those of Kalbers and Fogarty (1993:29) that measured the perception of audit committee diligence by CFOs, chief internal auditors, and external audit. Diligence was, *inter alia*, defined as the level of preparation, vigilance, independence, and level of activity of the ACC and other members. The results of the study indicated a positive relationship between diligence and perceived audit committee effectiveness and Kalbers and Fogarty (1993:24) concluded that the audit committee members' will to act is arguably the most important audit committee effectiveness attribute.

DeZoort et al. (2002:65) indicate the need to consider factors other than number of meetings, including litigation risk, reputation damage, possible loss of future board opportunities, and the relationship to audit committee member motivation.

The reasons individuals join audit committees could also impact on the diligence. Possible reasons provided during the fieldwork include financial remuneration, prestige, contacts, networking, and reputation. Audit committee members are usually reputable members of the business community and obtain additional membership and prestige when they demonstrate their ability to oversee and contribute to positive audit outcomes.

According to Circular 65 (National Treasury, 2012:4), which is relevant for audit committees in South African local government, audit committee members should possess the following attributes: perform an advisory role, communicate effectively with management, carefully review information received, raise relevant questions, evaluate responses and follow-up on unclear matters, conduct responsibilities in the context of the municipality's strategic objectives and overall corporate governance of the council, act independently and be proactive in advising the accounting officer, encourage openness and transparency, build relations with management, and have a professional approach including time commitment and effort. Audit committee reports usually disclose the number of meetings and attendance per individual member.

A possible contributing factor for audit committee diligence recognised in literature is the remuneration paid to audit committees. The next section includes information on audit committee remuneration.

## **5.9 Audit committees' remuneration**

The topic of audit committee remuneration, especially within the public sector, has been debated in various forums. It is necessary for the research to investigate some of the motivations and other studies on audit committee remuneration.

Studies in the private sector include that of Weiss (2005:86) that suggests audit committee monitoring is improved because compensation ensures the interest of the audit committee directors are aligned to those of the shareholders. The research by Weiss (2005:86) found that return on assets is increasing when management provided training and sufficient information to enable audit committees to fulfil their functions. Return on assets also increased

when audit committee members had in-depth knowledge of the firm's financial operations. She found a positive relationship between return on assets and audit committee oversight. She further suggested future research in differential compensation based upon the nature of the expertise (Weiss, 2005:86).

Engel, Hayes, and Wang (2010:153), as part of the research on determinants of audit committee compensation, found a positive correlation between proxies for the demand for monitoring of the financial reporting process and measures of audit committee quality. They also found that compensation is increasingly different for audit committee members, which suggests acknowledgement and willingness to compensate based on different contributions.

Magrane and Malthus (2010:437), in their study on effective audit committees in the public sector, made a general recommendation that audit committee members should be paid at a level that reflects the time it takes to carry out their duties with an allowance for particular skills brought to the committee. The audit committee members forming part of the study did not consider remuneration a factor in influencing participation on the AC. However, the ACC argued that compensation could be a factor because of it being much lower than the remuneration paid in the private sector. The internal auditor echoed the view of the chair in that some members would not attend meetings because it is not worth their while. The Auditor-General was also concerned that the level of compensation might not attract people with the required skills, including cases where experts need to be obtained as an additional resource to the audit committee.

Purcell et al. (2014:362), in their research of audit committees in Victoria local government, found audit committee effectiveness was perceived to be limited by the ability to attract and retain skilled independent members and variability of expertise and skills of councillors.

On remuneration of audit committees, a senior audit partner had the following to say: 'While the range of remuneration they might expect is not an insubstantial sum, it does need to be balanced against the personal exposure to reputational loss and the extensive workload which the chair of the audit is likely to shoulder, and all this in a non-executive role where direct influence is limited and reliance on others is nearly always necessary' (Roberts, 2016). The tariffs paid to audit committees in local government and recommended by National Treasury were considered to be very low by some of the participants during the fieldwork. If one considers this together with the extent of the responsibilities and reputational exposure of audit committee members, it further places a strain on the recruitment and attraction of audit committee members.

The attraction and retention of skilled independent members were identified as major challenges during the fieldwork. One of the reasons provided is the remuneration paid by local government and which is further discussed in Chapter 7. Circular 65 (National Treasury, 2019b) provides some guidance regarding audit committee remuneration. According to the circular, audit committees should be remunerated for time spent in attendance of audit committee meetings. The municipality may utilise the rates provided by the National Treasury or if allowed by council use other remuneration as stipulated in the charter. The circular also prohibits remuneration to be paid to any official employed at a national, provincial, or local government or other entities regarded as falling within the definition of an organ of state. These prohibitions further restrict the availability of the pool of suitable candidates to serve on audit committees as expressed during the fieldwork. National Treasury issues a circular on suggested tariffs for audit committee members from time to time (National Treasury, 2019b).

Research by Van Der Nest (2006:216-217) on audit committee effectiveness at national departments in South Africa indicated that most ACC indicated the remuneration paid to chairpersons and members of the audit committee was not enough to attract well-qualified members with expert knowledge. This view was shared by the other respondents and interviewees that formed part of the study. A recommendation was to base the hourly rate on the rates determined by the South African Institute of Chartered Accountants in consultation with the Auditor-General. It is further recommended that members are remunerated for preparation of meetings. This would ensure members of high professional status are attracted and could lead to audit committees making high-quality contributions. The same challenge still exists in local government.

An important process to provide information on the effectiveness determinants of the audit committee could be obtained through performance evaluations. The next section elaborates on performance evaluations of audit committees.

## **5.10 Audit committees' performance evaluation**

Davies (2009:60) concluded that the procedures for assessing performance are essential if the audit committee is to work effectively. Beasley et al. (2009:107), as part of the comprehensive research on oversight by audit committees, also assessed the performance evaluation process of audit committees. They found that most audit committees benchmark their practices against best practices through a formal process (53%) or through an informal process (22%) and 6% were starting to do performance evaluations. The methods used by



audit committees included self-evaluation (45%), feed-back from external auditor (38%), benchmarking against practices of other audit committees (31%), and feed-back from management, counsel, and internal audit (24%). In 17% of the cases, audit committees compared their charters with charters of other audit committees in the same industry and 28% of audit committees attended seminars.

Principle 9 of the King IV sector supplement recommends the council should ensure that the evaluation of the performance of its committees support continued improvement in performance and effectiveness (IODSA, 2016:84). Various forms of evaluation or performance assessment could be implemented. A self-evaluation review to improve effectiveness is one way in which the performance of the audit committee members can be assessed. Audit committee performance can also be assessed by compliance to the charter standards and assessing the participation of audit committee members during meetings, value-added activities, and outcomes achieved. The ACC should also review the performance of the members annually.

According to National Treasury guidance, possible key performance indicators for the audit committee could include the Auditor-General report on effectiveness of the AC, results of the AC's 360 degree assessment, the credibility of the audit committee statement in the annual report, proactive identification of emerging risks, and effective risk management committees and other governance committees (National Treasury, 2009:7-8).

In Circular 65, National Treasury requires that audit committees should assess performance and achievements against its charter on an annual basis, including the contributing performance of individual members. The circular recommends self-assessment, the results of which are presented to the accounting officer and municipal council by the chairperson. Consideration can be given to appoint an external facilitator to assist with or supervise the self-assessment process. Non-performance of the audit committee should be brought to the attention of the accounting officer and municipal council (National Treasury, 2012:9).

Van der Nest (2006:227) observed that effectiveness assessments of audit committees in general was not being performed and recommended that an audit committee self-assessment exercise be done for the audit committee.

Martinov-Bennie et al. (2015:749) found ad hoc, irregular, and in some cases complete absence of performance evaluations of audit committees. They also comment on the lack of research in the area of nature and extent of performance evaluations for audit committees

despite the recognition in research of the potential for performance evaluations to maximise effectiveness of audit committees. They state the following: 'If ... the audit committee is to have an increasing role in ensuring robust corporate governance and driving performance, then it is important that stakeholders can measure whether these expectations are being realised in organisational practice. ...organisations' reticence to subject their audit committee to more intensive scrutiny may be limiting both governance and performance across a range of organisational processes' (Martinov-Bennie et al., 2015:749).

The need for performance assessments have been included in all the audit committee charters reviewed. The following serves as an example:

The [audit committee] should assess its performance and achievements against its charter on an annual basis. The assessment must cover the performance of the individual member as part of the overall [audit committee] with reference to the particular skill the member has brought to the [audit committee] as a whole. ... The findings of the self-assessment should be presented by the chairperson to the Accounting Officer and ... Municipal Council. Where the self-assessment highlights a need for enhancements ... the chairperson should take action to ensure that such enhancements are implemented. ... Where the [audit committee] is not performing in accordance with the [audit committee] Charter and this has been observed by various stakeholders for example, external audit, internal audit or management, this or other issues will be brought to the attention of the accounting officer and municipal council. ... If an individual [audit committee] member is not performing the member must be given an opportunity to address such with the municipal council. If it is considered necessary to terminate the service of the [audit committee] member prior to the end of the term of appointment, proper procedures should be followed'.

During the fieldwork, the process of performance evaluation was also identified as an area that needs improvement and is further analysed in section 7.4.3.3.

## 5.11 Conclusion

This chapter describes the factors, identified in previous research and practice that enables the audit committee to perform effectively. Identified enabling factors include support by various parties and the power of the AC. The various determinants of audit committee effectiveness discussed as part of this chapter include: audit committee experience and expertise, composition and independence, authority, resources, diligence, and audit

committee remuneration. Throughout this chapter the characteristics of audit committee members and the chair have also been identified as an important dimension of effectiveness.

Per the empirical evidence, the authority and power of the audit committee is obtained through the audit committee charter and observable support from top management and the governing body. The audit committee needs to have adequate resources, including a sufficient number of audit committee members and access to management, external auditors, internal auditors, and the governing body and to accurate, timely, and complete information to be able to fulfil their responsibilities effectively. Time is another important resource for audit committee members and includes preparation time, formal meeting time, and time for informal interactions. As part of the discussion of having adequate time available, the impact of multiple directorships and tenure of audit committee appointments need to be considered.

Diligence is mostly researched by referring to the limited and narrow focus of the number of meetings attended by audit committee members per year due to it being a publicly quantifiable measurement. Other motivational factors for diligence could include, for example, the impact of penalties for poor audit committee performance, remuneration, and performance evaluations. However, various schools of thoughts on audit committee remuneration exist and are presented in the chapter. This chapter concludes with a section on performance evaluations of audit committees that should demonstrate to what extent audit committees are perceived to be effective.

The summary by Rittenberg and Nair (1993:25-26) on the determinants of effective audit committees is a good reflection of this chapter. According to them, the audit committee, as a standing committee of the governing body, derives its status and charter from the governing body and authority and power is limited to what is delegated to the audit committee by the governing body. Other important determinants include knowledge of accounting and auditing and a good internal control structure, the willingness to ask hard penetrating questions, and demonstrating insight and independence during meetings. Further determinants include diversity in membership and, due to the activities of the audit committee being very time-consuming, the individual must be committed to performing the public service. Also, of importance is having an attitude of healthy scepticism, time availability, and audit committee members being willing to set aside specific time to ensure they are up to date.

## CHAPTER SIX: DESCRIPTION OF RESEARCH METHODOLOGY

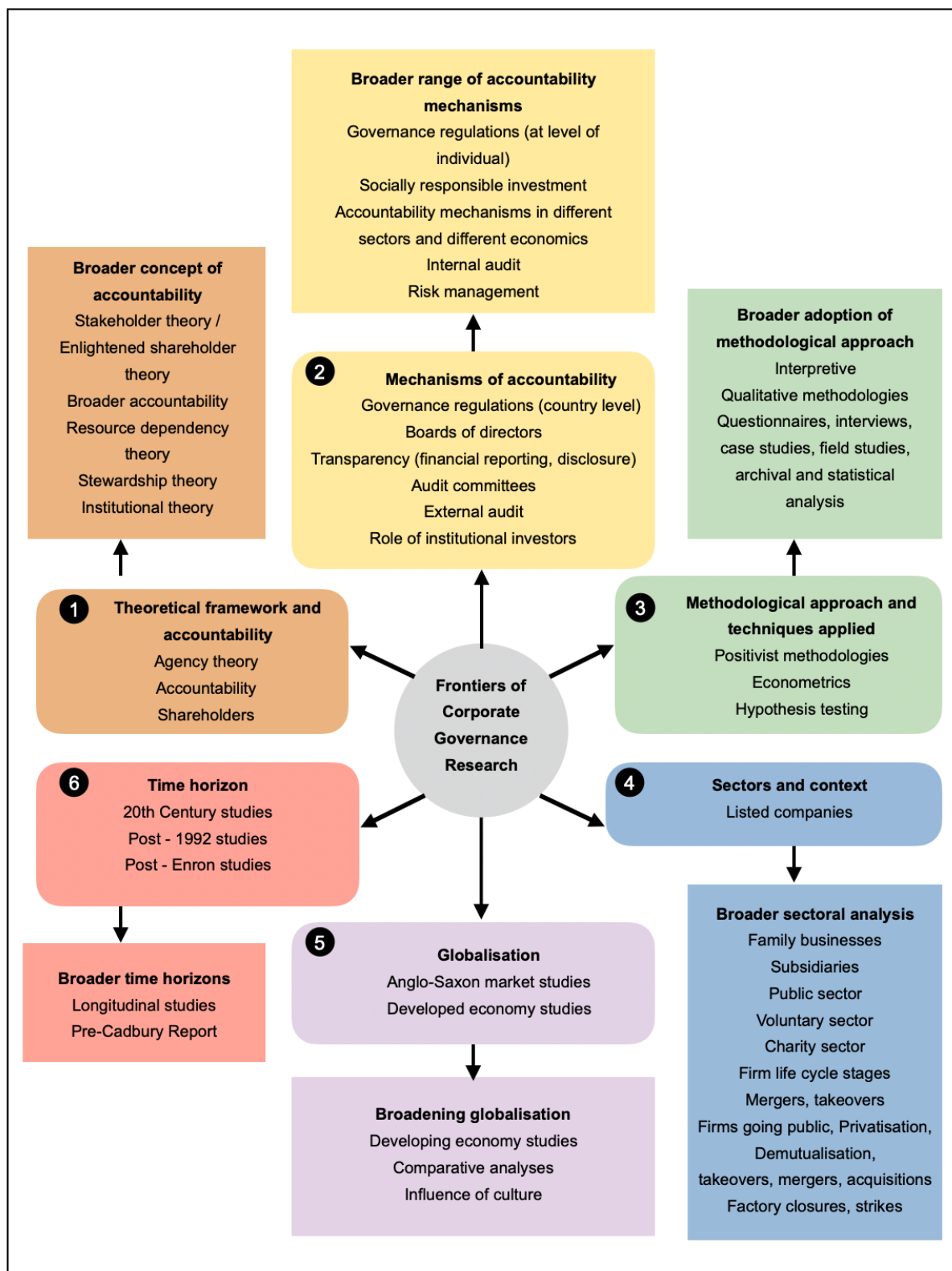
### 6.1 Introduction

The purpose of this research is to determine what practices, practitioners, and praxis are associated with effective audit committees in local government and investigate whether there is a gap between what is required of audit committees in terms of legislation and best practice and the expectations of stakeholders. This chapter describes the approach to the empirical study and the research methodology that was followed. The findings of the empirical study are presented and discussed in Chapter 7 and the conclusions and recommendations in Chapter 8.

Brennan and Solomon reviewed traditional corporate governance and accountability research to suggest opportunities for future research in corporate governance and accountability. This resulted in the development of an analytical frame of reference that was informed by careful analysis of the literature on corporate governance in the accounting and finance field and includes six elements: 1) theory; 2) accountability mechanisms; 3) methodology; 4) business sector/context; 5) globalisation; and 6) time horizon. They graphically depicted their interpretation of the focus of existing research in the six elements and then indicated the frontiers to show how researchers are starting to broaden their understanding and how research could be extended regarding these six elements. The analytical framework by Brennan and Solomon (2008:891) is presented in Figure 6.1. This framework is particularly useful as it situates where this research fits into the broad realm of research on corporate governance and accountability.

In this analytical frame of reference, the first element being the *theoretical framework and accountability* this research moves away from the traditional agency theory by using a hybrid of theories including agency, resource dependence, institutional and practice-orientated theory (see section 2.2.2). Related to the second element of *mechanisms of accountability* and the fourth element of *sectors and context*, this research, while focussing on the more traditional research area of audit committees, examines it from a different sector and different economies by focussing on the public sector and specifically local government, an area in which limited research has been completed, as argued in Chapter 1. Element five, *globalisation*, is also touched upon because South Africa is in many respects a developing country. This chapter further demonstrates how the methodological approach and techniques

applied in this research undertaking demonstrates innovation in the adoption of a broader methodological approach as part of new frontiers in corporate governance research.



**Figure 6.1. Brennan and Solomon's Frontiers of corporate governance research frontiers in accounting and finance linked informative to the study** (Brennan & Solomon, 2008:891).

The field of audit committee effectiveness research has been dominated by archival and survey methods acknowledged in the synthesis of audit committee literature by DeZoort et al. (2002) and evidenced by the review of academic literature discussed in Chapter 2. DeZoort et al. (2002:68:69) identified the need to consider alternative research methods to triangulate the literature and contribute to new theoretical and practical insights to improve the effectiveness of audit committees.

Evolving research perspectives include objectivism (quantitative, objectivist, scientific, experimentalist, traditionalist, and empiricist), interpretivism (qualitative, phenomenological, subjectivist, and humanistic), and constructivism. With the objectivism or objectivist perspective, the researcher is seemingly detached and an objective observer of observable social reality. The researcher/author is distant and has a 'god's eye' encapsulating the 'objective truth' rather than a subject involved in research (the 'I'). The first approach claims to have all the knowledge (already); the second approach is searching for (human) solutions within changing conditions (Liebenberg, 2013:50-67). With the interpretivism or interpretivist perspective the assumption is that reality exists and can be discovered by way of a systematic interactive methodological approach to understand motives/intentions/objectives. Constructivism assumes that there is no truth other than the narrative truth expressed by those who have experienced it personally (Schurink, 2012:16). This does not mean, however, that the narrative is untruthful or irrelevant/relativistic. The narrative brings important insights into the collage, debate, and research arenas that may assist in achieving forms of inter-subjectivity and, as such, contribute to solving immediate and foreseeable problems or challenges, i.e. in your field under study.

In the evolution of qualitative research, the notion of autoethnography has gained momentum over the past two decades. The researcher uses elements of autoethnography to add value to the study. As research is a process as contended by Mouton (2009), and taking into consideration the value of autoethnography as argued by Denzin (2006), Ellis and Bochner (2000), Garrat (2003), and Liebenberg (2008), this study was enriched by moments of autoethnography (the author's experience), the author being seen as one of the tools of research in qualitative and interpretative studies. Autoethnography is also increasingly being used in the areas of business and health sciences as well as management and industrial psychology (Etherington, 2006:140; Philaterou and Allen, 2006: 66ff; Crang and Cook, 2007:13). As a reflexive variant of the qualitative research tradition, it assisted in bringing about new insights to the results of the research and the case studies. While the

autoethnographic element does not feature throughout the study, it formed part of the study to provide a better understanding of the contemporary context and the role of the researcher working in the field.

Benecke, Schurink, and Roodt (2007:11-12) recognise that to enable the proper planning and execution of qualitative research, the researcher must be clear about his or her own scientific values including the researcher's ontology, epistemology, and position on personal beliefs and values. These values received continued attention throughout the research process.

In South Africa, in line with international trends, there has been an emphasis over the last few years on promoting the role and responsibilities of audit committees. Numerous professional publications have been issued, legislation enacted, and various guidelines developed as reflected on in Chapter 4. Capacity building initiatives have also been embarked upon. Despite the focus on the roles and responsibilities of the AC, as indicated in Chapter 1, the local government sphere is still experiencing immense governance related challenges. The study follows a qualitative approach using directed content analysis from a comprehensive review of academic, professional, and other materials to identify and discuss critical aspects on the practice, practitioners, and praxis impacting on audit committee effectiveness (included in Chapter 2). The directed content analysis formed the origin of the study and during data gathering and analysis the researcher allowed for themes to emerge from the data. Some of the initial themes identified, based on the literature review, include the composition of the AC, the important role of the ACC, the authority of the AC, the need for resources, the importance of stakeholder relationships, and diligence by audit committee members.

The research design is discussed in the next three sections and includes the reasons for selecting a qualitative approach through case studies including elements of the auto-ethnographical approach.



## 6.2 Research design

The study falls within the ambit of constructivism and is a qualitative study. Four of the most widely used qualitative approaches are phenomenology,<sup>75</sup> ethnography,<sup>76</sup> grounded theory,<sup>77</sup> and case studies<sup>78</sup> (Hair et al., 2007:300). The main approach used during this research will be the case study research approach. For the reasons set out above, I have used elements of autoethnography to add value to the study. The next three subsections include discussions and provide reasons for selecting the qualitative approach using the case study research approach, including elements of autoethnography.

### 6.2.1 Qualitative vs quantitative

This section starts with a description of the meaning of qualitative research, followed by examining the differences between quantitative and qualitative approaches, the advantages of using the qualitative approach, and the motivation for using the qualitative approach in this study.

Denzin and Lincoln (2011:3) describe qualitative research as:

“...a situated activity that locates the observer in the world. Qualitative research consists of a set of interpretive, material practices that make the world visible. These practices transform the world. They turn the world into a series of representations, including fieldnotes, interviews, conversations, photographs, recordings, and memos to the self. At this level, qualitative research involves an interpretive, naturalistic approach to the world. This means that qualitative researchers study things in their natural settings, attempting to make sense of or interpret phenomena in terms of the meanings people bring to them.”

McNulty et al. (2013:184) describe qualitative research as a ‘situated activity’ that takes place in the locale(s) of phenomena and covers the interpretations of role-players, relationships, and events in their natural settings. Particularly important is the issue of situated activity, which makes qualitative research and autoethnography so robust as a research approach. A survey that is done once-off (even if well-executed, quantified, and then analysed) can at most provide

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<sup>75</sup> Phenomenology – the study of how things appear in our experience and the meaning things have in one’s own experience.

<sup>76</sup> Ethnography – a qualitative description of human socio-cultural phenomena that focuses on a community and the participants are expected to represent an overview of the activities of the community.

<sup>77</sup> Grounded-theory – a process involving a set of steps that is carefully conducted and that will result in a good theory.

<sup>78</sup> Case studies are documented descriptions of a particular person, group, organisation, activity, or event. The actions taken by the individuals are described and their reactions, responses, and effects on other participants are compared to draw conclusions.

a 'snap-shot' or 'photographic moment', not immersed in experience and exposure to the local social or bureaucratic environment. Even longitudinal quantitative studies can compare only snapshots and fail to explain the dynamics of the social and policy process.

Creswell (2009:4) describes the characteristics of qualitative research to include emerging questions and procedures, data collection in the participant's setting, the researcher making interpretations of the meaning of the data, inductive data analysis moving from specifics to general themes, a focus on meanings of participants, and the importance to reflect the complexity of a situation.

The following eight criteria for excellent qualitative research has been defined by Tracy (2010:839): a worthy topic, rich rigour, sincerity, credibility, resonance, significant contribution, ethics, and meaningful coherence.

Bloomberg and Volpe (2016:41) identified the following key generic defining characteristics of qualitative research:

- It involves an interpretive naturalistic approach to the world where the researcher studies things and people in their natural settings.
- It is grounded in a philosophical position that is essentially constructivist being interested in how the complexities are experienced, interpreted, and understood in a particular context.
- The researcher is the primary instrument in the data collection and analysis due to the description, understanding, interpretation, and communication being the primary goals.
- The rich data that is contained in a real environment can only be captured if there is an interactive process between the researcher and the research participants.
- It involves the collection and study of a variety of empirical materials including the routine and problematic areas in the individuals' lives.
- There is design flexibility where the methods and tools can be modified to explore new insights and address revised research questions.

Erickson (2011:43) describes the difference between qualitative and quantitative inquiry as follows:

"Qualitative inquiry seeks to discover and to describe in narrative reporting meaning-relevant kinds of things focussing on the differences in the form of things that result in different meanings."

Erickson further explains:

“From Latin *qualitas* refers to a primary focus on the qualities, the features, of entities... while the contrasting term *quantitas* refers to a primary focus on differences in amount” (Erickson, 2011:43).

Zhang and Wildemuth (2005:1) explain the contrast in that with quantitative research the research specifications are determined before data gathering compared to qualitative research design, where it is usually worked out during the study. Another difference related to content analysis is that quantitative content analysis is deductive<sup>79</sup> and intended to test hypotheses or address questions generated from theories or previous empirical research, while qualitative content analysis is mainly inductive; it examines topics and themes and makes deductions from the data.

Denzin and Lincoln (2011:8) explain the differences in that quantitative studies focus on the measurement and analysis of causal relationships between variables rather than on processes, within a value-free context. Qualitative research focuses on the qualities of entities and processes and the meanings are not experimentally measured using, for example, quantity and frequency. Qualitative research stresses the intimate relationship between the researcher and the topic being studied. Denzin and Lincoln (2011:8) refer to the five significant differences between quantitative and qualitative approaches in ‘Research styles: doing the same things differently?’. The five differences/similarities are explained as follows:

Firstly, researchers argue that both quantitative and qualitative perspectives are shaped by positivism (there is a reality that needs to be studied, captured, and understood) and post-positivism (where it is argued that reality can never be fully apprehended and captured, only approximated and estimated). In this sense, post-positivism and post-modernism have similar traits, namely that reality is subjective, even solipsistic, and cannot be comprehended. Yet this is also a weakness of post-positivism and post-modernism, as if followed to its logical conclusion, no insights that can have a positive influence on agenda-setting, policy design, policy making, policy implementation can really be gained and evaluating the effects of policy is impossible.

Some feeling and insight into context and process and the need to communicate it to others such as the citizens, local government officials, or MMs and council can help even if it is not

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<sup>79</sup> Zhang and Wildemuth, in their chapter on *Qualitative analysis of content*, indicate that qualitative content analysis can incorporate inductive reasoning (themes and categories develop from the data through careful examination and constant comparison) and deductive reasoning where concepts or variables from theory and previous studies can prove to be very useful for qualitative research.

positivist in nature. To communicate context, process and experience remain necessary to ensure that policies can be amended – even scrapped and redesigned – to ensure a better, more humane, and sustained workability within the state, government, and society. The latter can only be achieved if the ‘discovered’ insights reached through qualitative research can be introduced into the public dialogue and governance practice/praxis to achieve some inter-subjectivity (or at least limited consensus) on policy adjustment, adaptation, or redesign. In ‘bettering the situation’ or enriching the policy environment, I take a cue from Meehan that ‘all systematic research should attempt to better life for some people somewhere’ (1988:8). I also take a cue from Popper discussed in Burke (1983: 180ff, 207f) and Brown (1986: 186, 200) that policies should be designed to reduce pain for the citizen (read: enhance quality of life). If a policy does not do that or has painful/destructive consequences or negative unintended consequences it needs to be adjusted or scrapped and redesigned. The latter two gentlemen took a moral stance and their approach is value laden. However, I agree with their assumptions when discussing democracy and empowering democratic governance-in-action. After all, why have policies if not for the good of human and non-human animals.

Postpositivism makes use of various methods to be able to capture as much of reality as possible with the emphasis on discovery and verification of theories. Denzin and Lincoln also refer to the description of Uwe Flick (2011:8-9) explaining that the quantitative approach has been used to identify cause and effect, operationalising theoretical relations, and measuring and quantifying phenomena, thereby being able to generalise findings. Although qualitative researchers in the postpositivist tradition will use statistical measures, methods, and documents, they do not report their findings by way of the complex statistical measures used by quantitative researchers.

Another element of doing the same things differently refers to the capturing of the individual’s point of view. Both quantitative and qualitative perspectives are concerned with the individual’s point of view. However, the qualitative researcher believes they can get closer to the subject’s perspective by way of interviews and observation. This is not possible for quantitative researchers being more remote and using empirical methods and materials.

The third difference explores the notion of examining the constraints of everyday life. Qualitative researchers experience the world in action and base their findings on that. Quantitative researchers are abstract from the world and do not study it directly. The following statement on qualitative researchers summarises it:

“Qualitative researchers...are committed to a...case-based position, which directs their attention to the specifics of a particular case” (Denzin & Lincoln, 2011:9).

Fourthly, qualitative researchers regard rich descriptions to be valuable, while quantitative researchers are not interested in such detail because the detail interrupts the process of developing generalisations. The literature review includes references to several researchers who promoted the need for qualitative research studies to be able to understand governance processes in action, including *inter alia* Ahrens et al., 2011:323, Brennan and Kirwan, 2015:481, Gendron, 2009:123, and Ghafran and O'Sullivan, 2013:400.

The need to study audit committees in natural settings to get a holistic understanding of the complexities being experienced within the specific context prompted the use of the qualitative approach for this study. The cultural and social environment and influences at each municipality are different, and different stakeholders and relationships and interactions impact on the effectiveness of audit committees. It added more value to obtain the richness of the information through a qualitative rather than a quantitative approach.

The last difference mentioned by Denzin and Lincoln (2011) refers to the acceptance of postmodern sensibilities. The use of quantitative, positivist methods has been rejected by a new generation of qualitative researchers in that it is considered a science where not all the voices are heard. In the literature review, the need to include all role-players as part of the research was also a recurring theme.

Lincoln and Guba (1985:296-300) identified the following alternative criteria to evaluate qualitative research compared to quantitative research to include credibility, transferability, dependability, and confirmability instead of the positivist notions of internal validity, generalisability, reliability, and objectivity.

The literature review also revealed that most researchers in the corporate governance and corporate governance structures, including audit committees, research fields use the quantitative approach (Turley & Zaman, 2007:767). An analysis of available academic literature, summarised in Annexure 1, confirms this preference. Turley and Zaman (2007:767) state that most researchers endeavoured to construct and test cross-sectional data sets but have relied on crude proxies such as number and duration of meetings to measure how active and effective audit committees are. These were crucial shortcomings of previous studies.

However, Spira (2006:181) identified a change in research on audit committees in that studies now follow a more sociologically based qualitative approach focussing more on the organisational context due to the dynamic nature of the development of audit committees. In

this regard, she refers to studies by Bédard, Chtourou & Courteau, (2004); Gendron, et al., (2004) and Spira, (1998).

The advantages of using the qualitative approach have been recognised by many researchers. Pillay (2006:446, 451) describes the importance of qualitative research as an important agent for policy analysis and policy change. Patton (2015:36-37) identifies five examples of the contributions of qualitative inquiry, including capturing stories to understand people's perspectives and experiences, explaining how systems function and the consequences thereof, understanding context and how and why it matters, identifying unanticipated consequences, and making a comparison between cases to discover important patterns and themes.

With qualitative research, the purpose is to provide a full and thick description that can be achieved by way of layered or multifaceted discovery leading to the mining of all data in the context (compare Neuman, 2007: 17,154; Liebenberg, 2008:93ff; Liebenberg, 2013:54ff). According to Terre Blanche, Kelly, and Durrheim (2006:272), the strength of qualitative research is its originality and closeness to sources. They state qualitative research goes 'beyond common sense' and provides for an 'interpretive perspective' providing multiple insights 'through understanding the context' (Terre Blanche et al., 2006:278).

Further benefits of using the qualitative approach are recognised by Zhang and Wildemuth (2005:11), who state that the results of qualitative content analysis can support the development of new theories and models, as well as validating existing theories and providing thick descriptions of particular settings or phenomena. This was confirmed by Brennan and Kirwan (2015:478), who recognise that qualitative research opens the possibility to adopt a wider variety of theoretical perspectives, which was done in this study by selecting the hybrid of theories included in section 2.2.2.

Through commentary, Gendron (2009) uses the study by Beasley et al. (2009:123) to discuss key challenges in carrying out qualitative research from a positivist stance and specifically to maintain the balance between methodological rigour and openness. He also reflects on the relevance of conducting qualitative research on accounting and corporate governance phenomena and begs for openness within the accounting research community for different ways to carry out research to understand the reality. He makes specific mention of the richness of the data gathered by Beasley et al. (2009:124), demonstrated by the numerous interview excerpts and the results of their study, which highlights the complexities around audit

committee practices and experiences that stress the relevance of qualitative research on accounting and corporate governance.

Beasley et al. (2009:66) conducted a qualitative study and were able to obtain extensive information about the audit committee process using in-depth interviews of 42 individuals that actively serve on United States public company audit committees. It shows the extent such human value insights can add to policy conceptualisation, making, execution and evaluation (via the 'feedback-loop'). The black box of policymaking, as refined by Parsons (1999), is relevant here. There are pressures, both external and internal, on what needs to be decided by the lawmaker and executive. These pressures and preferences need to be translated in outputs that meet the pressures and preferences by outside forces and inside agents (economy, citizens etc.) with policies that can solve problems or allow for good governance. How it works inside the box is difficult to understand (because it is the proverbial black box). To gain clarity, we need to investigate and try to understand what is happening inside the not-so-transparent black box.

One comment on the use of quantitative methods on governance research made by Carcello et al. (2011:20) is that much of the governance research focuses on only a single variable, for example, audit committee financial expertise, or a limited subset of governance characteristics. They consider this to have been appropriate at the initial phase of governance research but is often problematic due to the many governance characteristics that could affect the phenomenon being studied. The qualitative approach allows the researcher to examine a variety of governance characteristics without being confined to one or a few variables. This is confirmed by Patton (2015:22), who describes the benefits of qualitative research when compared to quantitative research, namely that qualitative methods produce a wealth of detailed information about a smaller number of people and cases and increases the level of understanding the cases and situations studied but decreases the generalisability.

McNulty et al. (2013:184) heed the need of further exploring the use of qualitative research in corporate governance and completed a focused review of published qualitative studies on corporate governance that appeared in scholarly journals between 1986 and 2011. They found 78 qualitative articles on governance topics. The results of the study found a growth in qualitative studies since the 1990s but that still represented only a small percentage of the published work on corporate governance; the majority of the publications were developed by United Kingdom scholars and published in European journals, covering different disciplines but the majority being in management and using a variety of methods with the most prevalent being interviews in combination with other methods. The results of their research show the



dominant focus of qualitative studies is the board of directors, including topics related to non-executive directors and board committees (49 studies). Other qualitative studies focussed on the effectiveness and interactions of governance mechanisms (12 studies), investors' and shareholders' involvement and consequences (nine studies), and management issues (eight studies). They urged for greater use of qualitative methods that explore processes and interactions in a real empirical context (McNulty et al., 2013:184).

The following statement by McNulty et al. (2013:190) comments on the benefits of qualitative study:

"However, without seeking to denigrate quantitative analysis, this prospect makes development of first-hand accounts that go beyond what is reported in the public domain and what is visible to the public gaze even more important to ensure that the field of governance research is not too far removed from the phenomena of interest and does not suffer from the dangers of studying the appearance of governance, but not its substance."

The literature review indicates studies on the ceremonial role audit committees play in the discussion of the institutional theory in section 2.2.1.3. One of the research objectives of this study is to determine whether audit committees provide substantive oversight or merely play a ceremonial role to create legitimacy, which can be determined by using a qualitative approach. Using a qualitative process can generate a wealth of information to inform and add to policy conceptualisation, implementation, and evaluation in the area of governance and audit committees in local government.

The study by Brennan and Kirwan (2015:471) acknowledges that few studies that examine audit committees from a practice perspective have been completed:

"...the practical application by, and understanding of, those charged with governance – moves research beyond generic governance structures towards the detailed functioning of governance subsystems, relationships and understandings of governance including its relations to other organisational practices. Focusing on the practices of audit committees will enhance researchers' understanding of what goes on in the social groups and will suggest avenues of exploration beyond those of prior research."

The purpose of this research study was to respond to this call by Brennan and Kirwan (2015) and through the qualitative approach examine the functioning of the AC, as well as the authority, relationships, organisational support, and interaction between the various role-players.

In South African studies on audit committee effectiveness, Marx (2008) and van der Nest (2006) also recognised the benefits of using a qualitative approach. Marx (2008) studied the effectiveness of audit committees at large listed companies in South Africa and Van der Nest (2006) the effectiveness of audit committees at national departments in the public sector.

Due to the unique and complex environment of local government and the various factors impacting individual municipalities, following a quantitative approach would not have enabled me to achieve the research objectives and obtain answers to the research questions. If the purpose of the research were to be achieved it was necessary to have an intensive engagement with the phenomena of audit committees in local government in real-world situations, which could only be achieved by using the qualitative method. In this study, the views of the mayor, MM, ACC, CAE, and the financial manager were obtained, making the qualitative approach adopted appropriate for the purpose. Henning, Van Rensburg, and Smit (2004:3) emphasise the importance of capturing the views of the subjects in the population under investigation in qualitative studies. Denzin (2006) concludes the strength of qualitative research methods is how it articulates the material impact of systems, legislative policies, and interpersonal interactions on individuals (Ellis, Bochner, Denzin, Lincoln, Morse, Pelias, & Richardson, 2008:276). This study incorporates all these elements.

Although much research on the effectiveness of audit committees has been done in the South African context, limited research on the effectiveness of audit committees, especially in local government, have been conducted, the latter which also supports the use of a qualitative approach.

Given the aim of the research, it is important to obtain first-hand knowledge of the research environment and avoid isolation from the people or events being studied in accordance with the suggestion by Ellis and Bochner (2000:126). The research design selected is appropriate for this study due to the value from an in-depth analysis of the practice, practitioners, and praxis impacting the effectiveness of audit committees through close interaction with the different role-players.

As recognised by various researchers, qualitative research methods lend themselves to a much more intense understanding of different interactions and processes across different levels of analysis and across different contexts (McNulty et al., 2013:190, Turley & Zaman, 2004:325). The difference in context between different municipalities and all the factors impacting the context have been highlighted throughout this research. The richness of

information obtained by using the qualitative approach necessary for answering the research questions is considered critical.

The selection of the qualitative approach as part of this study supports the need as reflected in the following quotes:

“Qualitative research provides a basis for rethinking and challenging some of the dominant assumptions and meanings about how governance actors and institutions function” (McNulty et al., 2013:183).

“Good governance requires a qualitative approach, not a mindless quantitative one. It requires integrity, objectivity, transparency, and accountability, built on a foundation of intellectual honesty” (IFAC and CIPFA, 2014:5).

The insights gained from an in-depth qualitative study assisted in improving an understanding of the practice, practitioners, and praxis affecting the effectiveness of audit committees in local government. The following section describes the meaning of the case study approach and the motivation for selecting it as part of the research design.

### **6.2.2 Case study methodology**

This section begins by reflecting on the meaning of the case study research methodology, followed by the advantages of using it and the motivations for selecting it for this research. The criticism against using the case study methodology is discussed under the limitations of the study in section 6.8.

One of the earlier descriptions of the case study research method is that of Yin (1994:13). The technical definition indicates the scope of the case study as follows:

1. A case study is an empirical inquiry. It
  - investigates a contemporary phenomenon within its real-life context, especially when
  - the boundaries between phenomenon and context are not evident (Yin, 1994:13).

Yin explains that because the phenomenon and context are not always distinguishable in real-life situations, other technical characteristics, including data collection and data analysis strategies, forms the second part of the technical definition:

## 2. The case study inquiry

- Copes with the technically distinctive situation in which there will be many more variables of interest than data points, and as one result.
- Relies on multiple sources of evidence, with data needing to converge in a triangulation fashion, and as another result.
- Benefits from the prior development of theoretical propositions to guide data collection and analysis (Yin, 1994:13).

Case study research is also described by Schwandt (2001:22-23), referring to Stake and Yin, as the method to be used when the researcher is looking for answers on how and why questions without having control over the events being studied; the object of the study is a contemporary phenomenon in a real-life context; and it is appropriate to use multiple sources of evidence. With case study research the researcher seeks to understand the matters fundamental to the case.

Gerring (2004:342) states that regrettably the term 'case study' is a definitional morass and over decades researchers have attached different meanings to it including the method being qualitative, small-*N*; the research being ethnographic, participant-observation or being *in the field*; the research being characterised by process tracing; and the investigation of the properties of a single case or a single phenomenon, instance or example. Gerring (2004) analyses the different definitions and concludes that the description of qualitative, ethnographic, and process-tracing describes a type of case study rather than the general phenomenon of a case study. He argues that the reference to a case study as a single case study is wrong because case studies always include more than one case. Gerring (2004) takes the definitional morass and transforms it into the following narrow and clear definition of a case study that, according to him and others, can be referred to when methodological confusions arise:

"An intensive study of a single unit for the purposes of understanding a larger class of (similar) units. A unit connotes a spatially bounded phenomenon ... observed at a single point in time or over some delimited period of time" (Gerring, 2004:342).

For methodological purposes, Gerring defines a case study as:

"An in-depth study of a single unit (a relatively bounded phenomenon) where the scholar's aim is to elucidate features of a larger class of similar phenomena" (Gerring, 2004:341).

Gerring (2004:342) continues to describe the different elements of the definition referring to a 'population' comprising of a 'sample' (studied cases), as well as unstudied cases. A sample comprises of several 'units' and each unit is observed at discrete points in time, comprising 'cases'. A case is comprised of several dimensions ('variables') each of which is built upon an 'observation' or observations.

Within the context of this study the description of Gerring (2004:342) is graphically depicted in Figure 6.2.

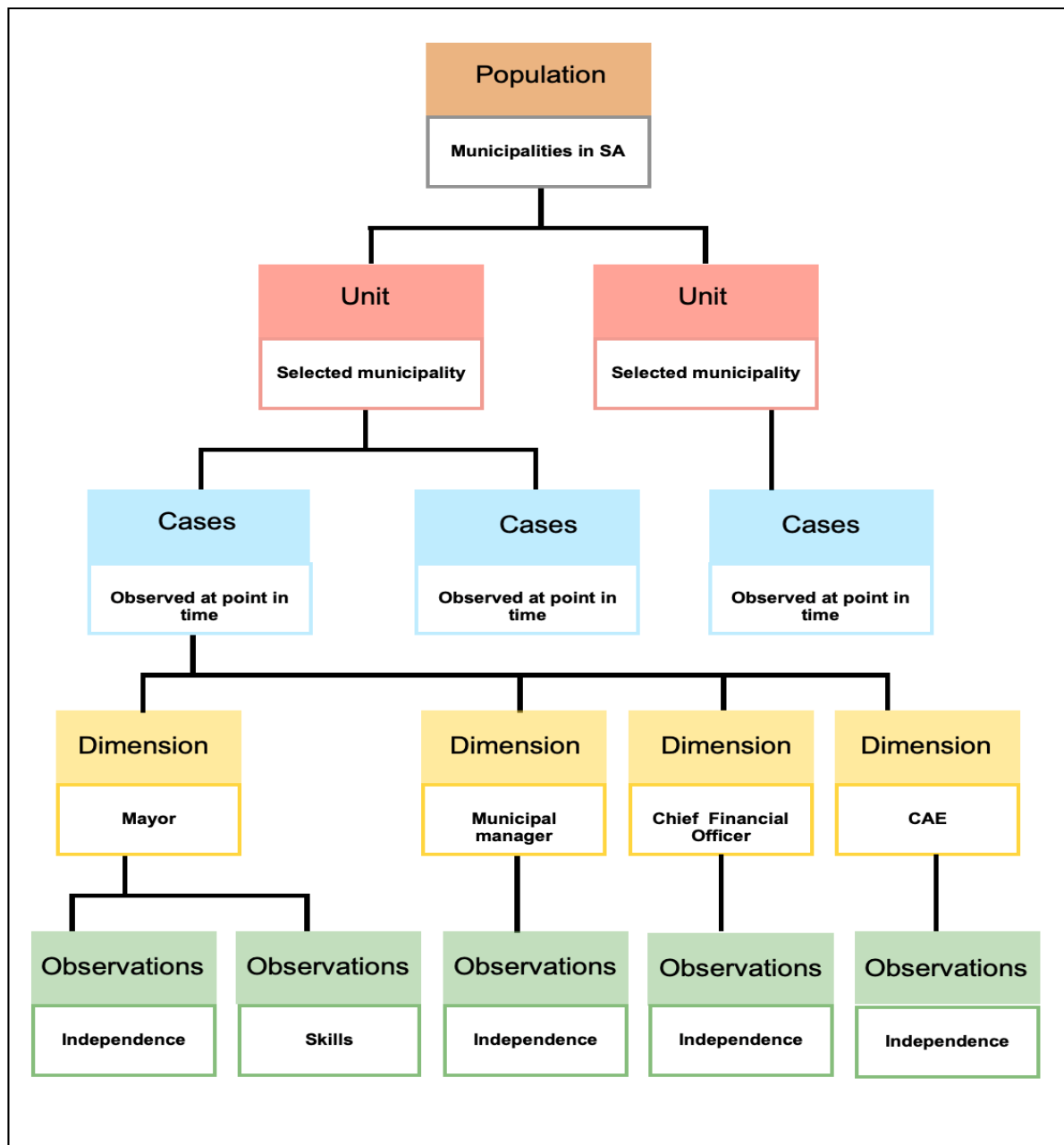
Jochner (2006) refers to descriptions of the case study by various academics including the descriptions by Clifford, Giddings, and Queen. Clifford's description is:

Case study method emphasizes the total situation or combination of factors, the description of the process or sequence of events in which the behaviour occurs, the study of individual behaviour in its total social setting, and comparison of cases leading to formulation of hypotheses (Jochner, 2006:41).

The description by Queen is:

...the case method is the examination of single situations, persons, groups, or institutions as complex whole to identify types and processes (Jochner, 2006:41).

Jochner (2006) refers to the emphasis by Giddings that by the case method the researcher ascertains as completely as possible the number and variety of traits, qualities, habits, or what not, combined in a particular instance. Jochner (2006:41) concludes with her own description: "Case history provides a method to study the process of interaction or association by showing how various physical, mental, and economic conditions and events may affect, as well as identify, relationships."



**Figure 6.2. Graphical depiction of the case study framework in the context of this research**

Zainal (2007:1) describes case study as a method to enable the researcher to closely examine the data within a specific context, where in most cases it encompasses a small geographical area or a very limited number of individuals as the subjects of the study.

Flyvbjerg (2011:301) describes a case study as 'an intensive analysis of an individual unit (as a person or community) stressing developmental factors in relation to environment'. He then continues by stating the decisive factor in defining a study as a case study is the choice of the individual unit of study and the setting of the boundaries.

Schurink (2012:31) states that a case study can be explained as an in-depth analysis of either one single or multiple cases over a period. The case study can be linked to a process, activity, event, programme, or individual/multiple individuals.

Slightly different from the 1994 definition described above Yin in 2018 provides an updated twofold definition where the first part deals with the scope of a case study:

A case study is an empirical method that

- investigates a contemporary phenomenon (the 'case') in depth and within its real-world context, especially when
- the boundaries between phenomenon and context may not be clearly evident.

and the second part with the features of a case study when doing case study research:

A case study

- copes with the technically distinctive situation in which there will be many more variable of interest than data points, and as one result
- benefits from the prior development of theoretical propositions to guide design, data collection, and analysis, and as another result
- relies on multiple sources of evidence, which data needing to converge in a triangulation fashion (Yin, 2018:15).

Gerring (2004:341) refers to the differences between case study and non-case study as being characteristics of strengths and weaknesses and affinities rather than opposing approaches to the empirical world. He also recognises the paradox that despite the widespread use of case studies to obtain information about the empirical world the method is held in low regard or even ignored.

The increased use of case study research is recognised in a later edition of Yin's (2018) book on case study research where one measurement for increased usage was that 15 different academic disciplines and practices had at least one specialised work focusing on case study research in the discipline or profession including that of accounting and public administration (Yin, 2018:xvi, 6). He further recognises the foundational trilogy of case study research, case studies, and case(s) where case study research focuses on the mode of inquiry, case studies refer to the method of inquiry or research method used in doing case study research, and cases to the unit/units of inquiry in a case study (Yin, 2018:xx). Yin (2018) refers to the use of case studies in everyday forms, such as in newspapers, magazines, and blogs and as part of supplementary professional training materials and refers to these as 'popular case studies'



and 'teaching case studies', respectively. He emphasises that these popular and teaching case studies do not necessarily follow any specific research procedures. The widespread use of these case studies has resulted in the impression of what a case study is and led people to believe case studies are a form of literary presentation or supplemental practice material and do not necessarily link it to the specific requirements of scientific research. The visibility and prevalence of the popular and teaching case studies may contribute to the sometimes-disapproving reputation of research case studies (Yin, 2018: xxi).

Researchers also distinguish between various types of case studies. Schurink (2012) refers to the three types of case studies identified by Schram and Stake, being intrinsic case study, instrumental case study, and collective case study. The main purpose of intrinsic case studies is to gain a better understanding of the case. Instrumental case studies extend to many cases that are chosen so that comparisons can be made between cases and concepts and in this way, theories can be extended and validated. The collective case study extends to several cases and the focus is to further understand or theorise about a general phenomenon (Stake, 2000:437). Schurink (2012:32) also refers to the three alternative classifications identified by Yin (2018), being exploratory, descriptive, and explanatory case studies. Exploratory allows for the exploration of the phenomenon, descriptive traces the sequence of interpersonal events over time, and explanatory presents opposing explanations for the same set of events and indicates how such explanations can apply to other situations.

The advantages of using case study methods have also been recognised. Bless and Higson-Smith (1995:43) describes one of the advantages being that cases show the operational reality of organisations and enable researchers to show the strengths and weaknesses of the organisations and make recommendations.

Gerring (2004:347-348) recognises that one of the primary advantages of the case study method is the depth of the analysis that can be achieved compared to cross-unit studies that are likely to explain only a small portion of the variance with respect to an outcome or the approach to the outcome is at a general level. Gerring (2004:341) concludes:

"Judging by recent scholarly output, the case study method retains considerable appeal, even among scholars in research communities not traditionally associated with this style of research ... the method of case study is solidly ensconced and perhaps, even thriving."

Nicholson and Kiel (2007:604) conclude that the case study method provides richer forms of data and new tools to analyse the complex processes involved in the governance body and the impact on organisational performance. Liebenberg (2013:65) describes the benefits of

case studies to provide the capacity to explore processes as they develop and unfold, being extremely useful to understand processes in their environmental context and to explore perceived new processes and activities.

Cooper and Morgan (2008:160), in their study on the applicability of case study research in the accounting field, note that case study approaches are especially well-suited to examine complex phenomena with many variables impacting thereon, actual practices and details of significant activities including ordinary, unusual, or less frequent and phenomena where the context is crucial because the context affects the phenomena and vice versa. Case studies answer the how and why questions and for practitioners the answers to the 'how' questions are particularly useful in that details that are otherwise in the reports or minds of the innovators become publicly available information. This study particularly researches the practices, practitioners, and praxis of audit committees in specific cases – the selected municipalities - to reflect on how and why it impacts the performance of the audit committees.

The advantages of using case studies in the accounting field identified by the researchers include the opportunity to understand meaningful differences rather than general characteristics (Cooper & Morgan, 2008:161). One of the cases discussed by Cooper and Morgan (2008:168) that resonates with this research is that of Pentland, where two audit teams were studied to better understand how the auditors become comfortable with numbers and representations provided by management. This is like audit committees' need to be comfortable with the information provided by management to enable them to fulfil their oversight and advisory role. In the case of Pentland, it was found that case studies are particularly suited for research questions that endeavour to understand complex human behaviour, in that case the auditors, having intensive, ongoing interactions with other members of the audit team, the organisation, and their profession (Cooper & Morgan, 2008:168).

Erickson (2011:53) refers to the argument for the use of case studies by Flyvbjerg (2011) to address matters of value, power, and local detail, as these are pertinent to policy decision-making that cannot be based on general knowledge but should be informed by information on the specific circumstances of the local situation.

Within the audit committee effectiveness arena, various researchers use the case study method. Gendron et al. (2004:156), in their study on the effectiveness of audit committees,

selected to use the field study method<sup>80</sup> because the purpose was understandability rather than generalisability due to the scarcity of knowledge on the practices of audit committees. Likewise, in South Africa, limited studies have been completed and limited information is available on the practices and praxis of audit committees in local government.

Turley and Zaman's (2007:782) through case studies found evidence of the audit committees' impact on governance outcomes; tensions impacting on the contribution audit committees can make and the impact the audit committee have on other organisational participants. They conclude that through the case study they were able to identify several significant factors that would not have been observable from publicly available information sources and revealed internal perceptions and information reflecting on the governance contributions of audit committees.

Turley and Zaman (2004:325), on the use of case study for audit committee research, conclude as follows:

"Much of the existing body of audit committee research has been based on large samples, utilising publicly available and/or questionnaire data which rarely reflect the practical reality of audit committees' operation and their effects. The impact of audit committees cannot be adequately investigated using solely questionnaire surveys and analysis of databases. Qualitative research methods incorporating case studies and interviews provide significant potential for researching audit committees' activities in the organizational and institutional context in which they operate. In particular, cases may allow identification of specific independence and audit process effects and recognition of the complex environment of the audit committee and the interaction of the audit committee with other parties such as executive management and auditors."

A similar view was shared by Carcello et al. (2011:19):

"In our view, given the need to focus more on board and board committee processes, future research in governance will need to rely more on experiments, particularly those examining group interactions, and field studies."

Sarens et al. (2009:90) used four case studies to research what drives the audit committee to look for support from the IAF and what makes the IAF an expert at providing comfort to the audit committee.

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<sup>80</sup> Cooper and Morgan state various terms can be used for case studies including field studies, interpretive studies, qualitative research small sample studies, action research, and constructive research (2008:160).

Table 6.1 reflects an extraction of the main and consistent criteria for a case study based on the description of case studies by various researchers described above and the applicability to this research on the practice, practitioners and praxis of local government audit committees at selected municipalities.

**Table 6.1: Link between case study criteria and research on selected municipalities**

Case study criteria	Applicability to this research
Explores contemporary phenomenon in real-life context	√ Research focus on audit committees – being topical – and uses interviews with various role-players involved with audit committees
Bounded by time	√ Research includes the perspectives of the various role-players over a period of time in dealing with the audit committee.
Bounded by activity	√ Bounded by municipality and specific audit committee activities
Collects detailed information and a variety of collection procedures and uses multiple sources	√ Information obtained by scrutinising public and non-public available information as well as in-depth interviews with stakeholders and audit committee chairperson
Look for answers on why and how	√ Reflected in research questions
Spatially bounded	√ Sample consists of selected municipalities in Western Cape and Northern Cape

Various reasons and motivations for selecting the case study as an appropriate research design method for this study exist. The literature review and research problems identified demonstrate that the answers to the research questions would not necessarily be provided through field experiments, natural experiments, or statistical evidence but rather taking the context of the municipal environment and the role-players in that environment into account.

Another methodological consideration is the practicality of the research design and specifically the difficulty in collecting original data.

A further reason for selecting the case study as a research method is that it allowed me numerous observations of a single case, thereby providing more evidence of what practice, practitioners, and praxis exist at each municipality.

The last consideration before selecting the case study method was the state of research on the topic. The literature review indicates limited research on audit committees have used the case study method and no research on audit committees in local government in South Africa using the case study method, that would provide in-depth information have been completed.

With this study, the researcher aims to intensively study audit committees in a sample of seven municipalities – being spatially bounded – studying the different cases within each of the municipalities relating to the practice, practitioners, and praxis of the audit committees.

### 6.2.3 Autoethnography

A unique feature of this study is the sharing of personal knowledge and experience gained while serving as an audit committee member and on occasions as ACC for over 20 years. Terre Blanche et al. (2006:276) also refer to ‘the self as instrument’ or the researcher himself/herself being one of the tools in the research process. As questioned by Ellis and Bochner (2000:734), how can the author’s personal feelings and thoughts not be considered seeing that it is the person collecting the evidence, drawing the inferences, and reaching the conclusions. In Anderson’s (2006:376) capture of the history of autoethnography he recognises that elements of autoethnography and autobiography have always been part of qualitative sociological research but were not necessarily self-observational in the method or self-visible in the text.

Erickson (2011:52) makes the following statement:

“One of the ways to demystify the text of qualitative research report is to include the author (and the author’s ‘standpoint’ perspectives) as an explicit presence in the fieldwork.”

Altheide and Johnson (2011:382), on their reflections on interpretive adequacy in qualitative research, state that many insights found in qualitative research originate in the personal experience of the researchers and the present research would be incomplete unless some personal experiences are shared.

This section begins by explaining what is meant by autoethnography and the motivation for selecting the partial application thereof in this study.

Ellis and Bochner (2000:739) describe autoethnography as follows:

“Autoethnography is an autobiographical genre of writing and research that displays multiple layers of consciousness, connecting the personal to the cultural. Back and forth

autoethnographers gaze, first through an ethnographic wide-angle lens, focussing outward on social and cultural aspects of their personal experience; then, they look inward, exposing a vulnerable self that is moved by and may move through, refract, and resist cultural interpretations... Usually written in first-person voice, autoethnographic texts appear in a variety of forms – short stories, poetry, fiction, novels, photographic essays, personal essays, journals, fragmented and layered writing.”

For this reason, autoethnography is seen as ‘too close up and personal’ or is ‘research against the grain’ (Liebenberg, 2013:50). Such critics underestimate the complexities of being in the woods (of experience or/and research).

Burnier’s (2006:412) description of autoethnography captures the complexities:

“Personal writing is hybrid in character, in that it blends and combines an individual’s personal story with his or her scholarly story. It is writing that is not strictly scholarly because it contains the personal, and yet it is not strictly personal because it contains the scholarly.... [it] seeks to erase the false dichotomy between the scholarly and the personal.”

Tracy (2010:842) includes sincerity as one of the criteria for excellent qualitative research. According to her, self-reflexivity as part of sincerity encourages the researcher to be honest about their strengths and weaknesses. ‘Ethnographers should report their own voice in relation to others and explicate *how* they claim to know what they know’. According to Tracy (2010:842), good ethnography is not limited to information and knowledge about others but should also include stories about oneself to expand on the information about the research area. Ellingson (2011:599) refers to her earlier definition, describing autoethnography as ‘research, writing, story, and method that links the autobiographical to the cultural, social, and political through the study of a culture or phenomenon that one is a part of or that is integrated with relational and personal experiences’. This study considers the necessary relationships the audit committees need to have to ensure effective execution of their roles and responsibilities as part of the research question and examines whether there is a gap between what is required of audit committees and the expectations of stakeholders and why. Being a member of audit committees over a long period provides relational and personal experiences that can be shared.

Spry (2013:215) describes performance autoethnography as a ‘critically reflexive methodology resulting in a narrative of the researcher’s engagement with others in a particular sociocultural context’. Liebenberg (2013:50) describes autoethnography as:

“...the reflected-upon-experience of the researcher as one of the tools of the research. Personal examples and reflections are crucial and add value to the narrative of the self and others within the social context.”

Throughout the study, the researcher have critically reflected on lived experiences in the environment of performing the functions of an audit committee member and have attempted to tell the story and criticism in fulfilling this role.

Through autoethnography the performer can use lived experiences and personal history to tell their story with the purpose to critique oneself (as an audit committee member) and society (local government), as well as oneself in the society and the self, playing a transformative force in society (Alexander, 2005:423).

Denshire (2013:1-2) acknowledges that autoethnographic writing has become increasingly common in different disciplines, including experiences in professional practice, and used the autoethnography method to write on her over 30 years' experience as a practitioner-researcher of occupational therapy. Autoethnography is more than autobiography but includes personal and professional experiences in an area where there can be unbalanced power and a tendency to depersonalise the cultural and social aspects in the research area.

The editors of the Academy of Management Journal also embraced the developments in the diversity of qualitative methods. They reviewed the qualitative articles published in the journal over 10 years and identified some gaps and opportunities. One such opportunity is to encourage non-traditional data sources like interviews, observation, and archival sources and to draw more from diverse sources, including narratives (Bansal & Corley, 2011:235).

Ellis and Bochner (2000:740) recognise that authoethnographers vary in their emphasis on the research process (graphy), on culture (ethno), and on self (auto), and different examples of autoethnography fall at different places along the scale of each of the three axes. They demonstrate the range of approaches by describing some of the approaches, including personal narratives and reflexive ethnographics. In personal narrative, the researcher adopts the identity of the academic and personal self to tell autobiographical stories about some aspects of their experience in daily life. In reflexive ethnographies, the researcher's personal experience becomes important in how it highlights the culture under study (2000:740).

In later research, Ellis and Bochner (2006:431-432) describe different approaches in autoethnography to include evocative and analytical approaches. Evocative autoethnography



refers to the writer's personal stories and follows a descriptive literary approach, while analytical autoethnography links to a broader set of social phenomena (Anderson, 2006:375). Anderson (2006:375) describes the elements of analytic ethnography to include: 1) the researcher being a full member in the research group or setting, 2) visible as such a member in the published text of the researcher, and 3) committed to an analytic research agenda that focus on improving theoretical understanding of a broader social phenomena. The intention of this section is not to enter the debate between evocative and analytical autoethnography but to share experiences and feelings of myself as part of this thesis. In the partial application of autoethnography I have endeavoured to comply with the criteria put forward by Jones in looking at the work of other autoethnographers. These criteria include: 1) participation as reciprocity; 2) partiality, reflexivity; and citationality as strategies for dialogue; 3) dialogue as a space of debate and negotiation; 4) personal narrative and storytelling as an obligation to critique; 5) evocation and emotion as incitements to action; and 6) engaged embodiment as a condition of change (Jones, 2005:773).

My primary reason for bringing in my own experience is to create a more equitable relationship between myself and those that I study by subjecting myself and other audit committee members and affected parties to the analytic lens. I believe that exploring the topic and the research questions together with my own experience provides a more complete picture.

### 6.3 Sample selection

Sampling for qualitative content analysis usually entails purposively selected texts that can inform the research question being investigated (Zhang & Wildemuth, 2005:2). Schwandt (2001:23) recognises that cases can be chosen for research because they are thought to be contributory in furthering understanding of a specific problem, issue, or concept and can be used for theoretical elaboration or analytical generalisation.

Stake (2000:435) recognises that case studies are a common way of doing qualitative inquiry and a case study is not a methodological choice but a choice of what is to be studied. Flyvbjerg (2011:301) agrees that the choice to do a case study is not so much about the methodological choice as the choice of what should be studied, the choice of the individual unit of study, and setting the boundaries.

The importance of identifying the case to be studied is also identified by Yin (2018:30-31) as being one of the central components of research design. He distinguishes between two

different steps: defining the case and bounding the case. In defining the case, the research questions should lead you to favour one case above another.

As part of the research design of this study, a decision was made to use a multi-case design rather than a single-case study design because evidence from multiple cases is often considered to be more persuasive and more robust (Yin, 2018:54).

Flyvbjerg (2011:307) includes a summary of the strategies for the selection of samples and cases and distinguishes between random selection and information-oriented selection. Flyvbjerg (2011:306) states that when the purpose of a study is to gain the maximum amount of information on a problem or phenomenon, a representative case or a random sample is not necessarily the most appropriate strategy. This is because the average or typical case does not always contain in-depth information, while unusual or extreme cases often reveal more detailed information. Information-oriented selection can consist of four types, including extreme/deviant cases, maximum variation cases, critical cases, and paradigmatic cases, also discussed by Cooper and Morgan (2008:166) in their study on case study research in accounting. Table 6.2 distinguishes between the purposes of the different types of case studies.

**Table 6.2: Purpose of different types of case studies**

Type of selection	Purpose
Extreme/deviant cases	By looking at outliers (could be problematic or good) or deviant cases significant knowledge can be obtained, and it can be powerful to communicate an idea or examine the boundary conditions of a theory.
Maximum variation cases	This type of case study provides a valuable understanding of a specific problem by selecting cases that are different in some dimension (could be for example size, form of organisation, location, budget). The significance of the dimensions for processes or outcomes of interest can then be determined
Critical cases	These are for cases with strategic importance for a general problem or theory. In this way a new theory can be tested, revised, or developed. In this type the researcher has a well-developed theory and a case is selected based on the idea that it will provide a better understanding of the circumstances that will either confirm the hypothesis or not.
Paradigmatic cases	This can provide important information about a situation with the purpose to demonstrate the value of new theories.

Adapted from: Bryman (2012) and Cooper and Morgan (2008).

The purpose of this study is not to develop theory (the extreme case) or formulate a type of generalisation (the critical case), but rather to have strategic importance (the role of audit committees) in relation to a general problem (governance problems in local government) and to obtain information about the various circumstances for case process and outcome.

For this study, the first step recommended by Yin (2018:32), namely defining the cases, is the selection of the municipalities. Selecting municipalities as cases is in line with the recommendation by Yin (2018:32) that distinguishes between concrete case studies, which includes both organisations and less concrete case studies. The next step recommended is to bound the case. During the analysis of the various definitions of case studies, a recurring criterion is bounding either by time or activity, or spatially. He also explains bounding by referring to the relevant social group, organisation, or geographic area, as well as the time covered by the case study (Yin, 2018:32).

Local government consists of 257 municipalities in South Africa, comprising eight metropolitan, 44 districts, and 205 local municipalities (Main, 2019). The research questions informed the decision to select municipalities in two of the nine provinces, being the Western Cape and the Northern Cape. The selection of these two provinces is based on the approach to select cases representing variation types, namely successful and less successful provinces based on the audit outcomes of the Auditor-General (Auditor-General, 2013, 2014 and 2017). In the 2013/14 consolidated general report, the Auditor-General categorised municipalities in three outcomes areas: strong financial management and control disciplines, limited positive movement with significant financial management, and control deficiencies and weak financial management disciplines with significant control weaknesses. For sample selection, the Western Cape and Northern Cape were selected for research. The Western Cape is categorised as a strong financial management and control discipline category and the Northern Cape as a province where significant financial management and control weaknesses exist.

The Auditor-General further reiterated the state of outcomes in the different provinces:

The Western Cape continued with setting the pace by increasing their clean audit opinions to 80% of their municipalities (2013/2014 report).

The provinces with the poorest outcomes (based on the number of municipalities with disclaimed and adverse opinions or outstanding audits were **North West** (35%), the **Northern Cape** (31%), and the **Free State** (29%) (Auditor-General, 2017:10).

The trend continued with the audit outcomes of the Western Cape being positive compared to less positive audit outcomes in the Northern Cape. The primary research question is to establish the practice, practitioners, and praxis associated with effective audit committees in local government and the reasons why. Audit committees play a key role in providing advice

on governance and financial and performance areas in local government, as discussed in Chapter 4. Therefore, for this study, maximum variance cases are appropriate in selecting the cases and answering the research questions. Through selection of the cases in these two provinces, maximum information on the various circumstances and context could be considered. In accordance with the description of Cooper and Morgan (2008), the cases are in different locations and have different audit outcome results. Yin (2018:60) also refers to the use of 'two tail' design where cases from both extremes have been deliberately chosen.

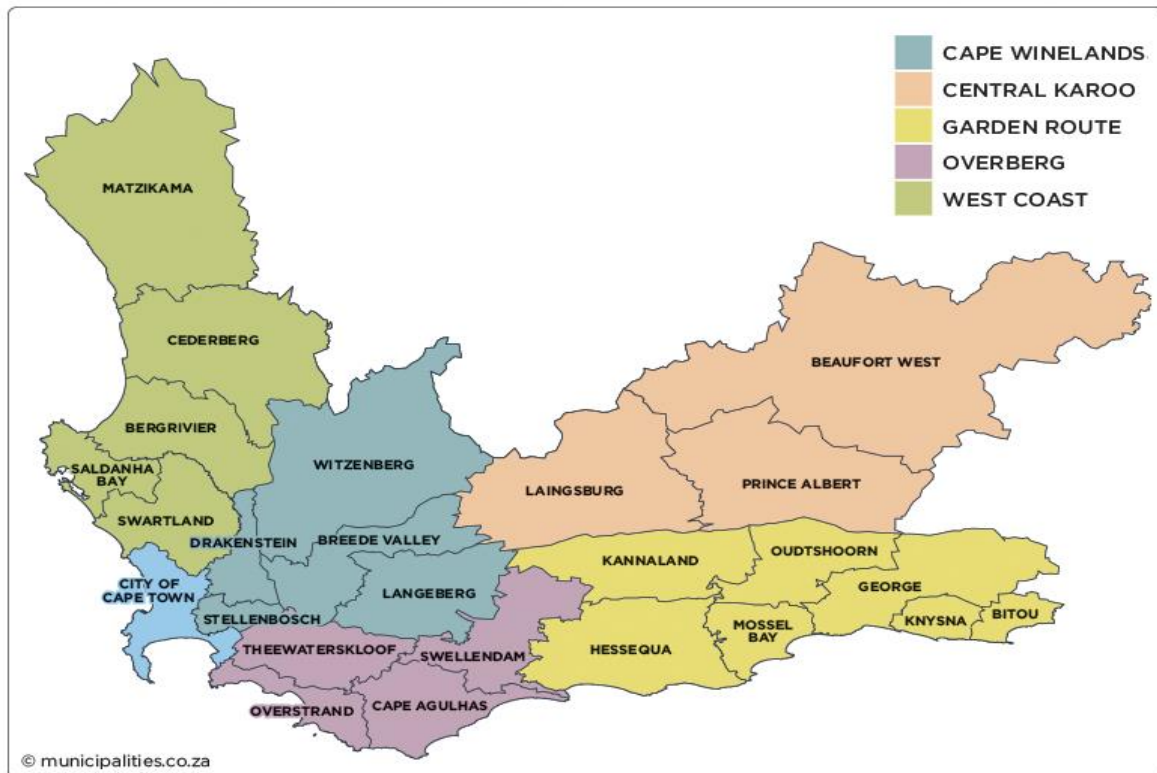
The selection of municipalities in the two provinces complies with the requirements of defining geographical boundaries (spatial bounding), focussing on audit committees (bounding by activity), and the social group, comprising of the role-players that deal with the audit committee as part of the practices, practitioner, and praxis including the mayor, MM, CFO and CAE.

The next decision was to select specific municipalities within the two provinces. Cooper and Morgan recommend three to four cases maximum for variation types of case studies.

Part of this research involved carefully studying the general outcome reports of the Auditor-General over three years (2015-2016 to 2017-18), and it was possible to select a sample of two local municipalities and one district municipality in each of the two provinces in South Africa with positive and less positive audit outcomes. The results of the pilot study municipality were also included in the final analysis due to the richness of the information obtained during the pilot study. In total four municipalities in the Western Cape and three municipalities in the Northern Cape formed part of the analysis presented in Chapter 7.

The Auditor-General in the audit outcome reports distinguished between financial statement qualification areas, predetermined objectives (non-financial information) findings, findings on compliance, findings on specific risk areas, and the extent of unauthorised, irregular, and fruitless and wasteful expenditure.

The Western Cape consists of five districts including the Cape Winelands, Central Karoo, Garden Route, Overberg, and West Coast and the different municipalities are reflected in Figure 6.3 below. Within the Western Cape, it was decided to select one district municipality and two local municipalities in one of the five districts. For this study and for complying with the confidentiality agreement, the municipalities have been numbered sequentially from 1-7.



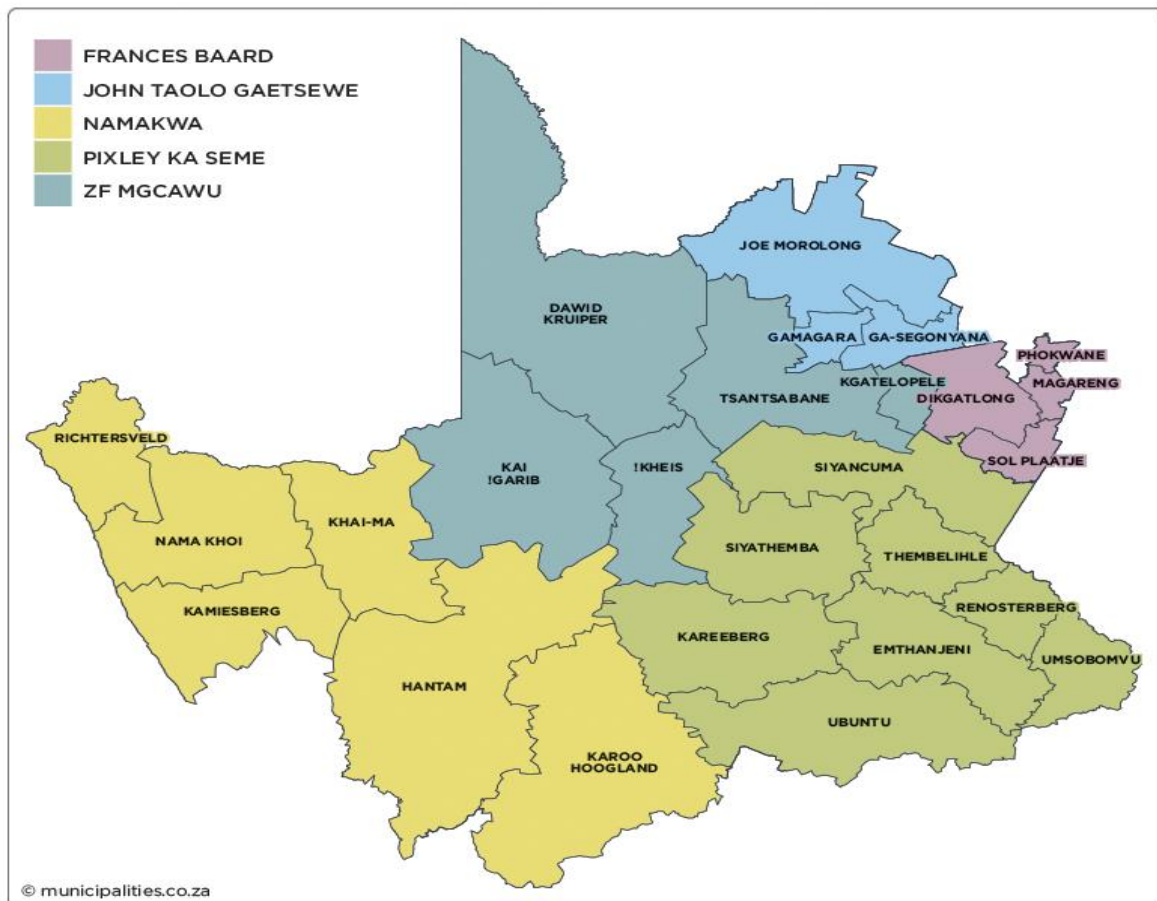
**Figure 6.3. Map of municipalities in the Western Cape**

Source: [Online] available at <https://municipalities.co.za/provinces/view/9/western-cape>, [Accessed 25 August 2019]

The Northern Cape consists of five districts, including Frances Baard, John Taolo Gaetsewe, Namakwa, Pixley Ka Seme, and ZF MgCawu districts, and the different municipalities are reflected in Figure 6.4.

The audit outcomes of MUN 1, MUN4, MUN5 and MUN6 reflect audit opinions of unqualified with no findings (the most positive audit opinion) for each of the three years analysed. MUN2 and MUN7 received unqualified with findings audit opinions on financial statements, performance reports, and compliance with legislation showing a stagnation or regress over the three years with repeat findings on non-compliance. MUN3 showed a qualified with findings audit opinions (negative) with repeat negative findings on performance information, compliance with legislation, and negative repeat findings in 70% and more of the areas reported on by the Auditor-General.

The Auditor-General raised concerns about the quality of submitted performance reports (non-financial information), information technology, supply chain management, human resource management and financial health during the three years at these municipalities.



**Figure 6.4. Map of municipalities in the Northern Cape**

Source: [Online] available at <https://municipalities.co.za/provinces/view/7/northern-cape>, [Accessed 25 August 2019]

The next section describes the participants and reasons for selecting them as participants of this research.

## 6.4 Participant selection

Literature has indicated the need to consider internal and external interrelationships between the various actors and mechanisms that affect corporate governance. Cohen et al. (2008:194) suggest that from the standpoint of internal relationships, researchers should study interactions between the AC, external and internal auditors, and the board and management as it may influence the effectiveness of the governance system.



Section 166 of the MFMA (RSA, 2003) requires of each municipality to have an audit committee who must advise the municipal council, the political office-bearers, the accounting officer, and the management staff of the municipality on various matters.

For this research and based on legislative and other requirements (Chapter 4) as well as the literature review (Chapter 2), participants who deal with the audit committee or who have an interest in the activities and results of audit committee activities were identified to include the council, the MM, the financial manager and other executive managers and CAE. Chapter 3 of this study (in section 3.2) describes the different role-players and the interaction with the audit committee in more detail. The audit committee is a sub-committee of the council, meaning that the council should take an interest in the work and results of the activities performed by the AC. The representative of the council is the mayor, selected as one of the participants of this study. The accounting officer, or in the context of local government the MM, was identified as another necessary participant in this study. For this research, the MM was identified as the participant to represent the rest of the executive managers. However, due to the nature and focus of the audit committee on the financial information of the municipality, it was considered important to have separate interactions with the CFO, being accountable for the financial management of the municipality. The audit committee also plays a critical role in overseeing the internal audit and the CAE as representative of the IAF was selected as a participant. A total of 29 interviewees were conducted as part of this research (Table 7.2).

## 6.5 Data ‘gathering’

According to Denzin and Lincoln (2011:14), the case study methodology relies on interviewing, observing, and document analysis. All these methods were used as part of the study and are further elaborated on.

### 6.5.1 Interviewing

Fontana and Frey (2000:645-646) recognise interviewing to be one of the most common and powerful ways to get an understanding of the subject matter and the most common form of interviewing is a face-to-face verbal interchange. However, interviews should not only be regarded as data gathering but as active interactions between parties that lead to negotiated, contextually based results. Fontana and Frey (2000:663) see the trend in interviewing to be more of participation and negotiated accomplishments by both the interviewer and respondent taking the context and situations in which the interviews are taking place into account.



According to Birkinshaw, Brannen and Tung (2011:574), direct, first-hand engagement is one of the distinguishing features of qualitative research.

Rubin and Rubin (2012:3-4) discuss the benefits of in-depth interviewing to include: Enabling the exploration in detail of experiences, motives, and opinions from those that have knowledge and experience. By collating the descriptions from separate interviews, researchers are able to create portraits of complicated processes. Through interviewing the researcher can explore multiple perspectives and by listening to different versions be able to reach more thoughtful and nuanced conclusions.

McNulty et al. (2013:190), in their study on the use of qualitative research in corporate governance, found the dominant qualitative method is the interview (62 studies), followed by archival data (22 studies), observation (12 studies), survey (12 studies) and participant observation (6 studies).

DeZoort et al. (2002:66), in their research on available literature of audit committee effectiveness, have identified numerous areas<sup>81</sup> for further research. They urge the need to push audit committee research beyond individual-based studies. They recognise practical constraints but indicate methods such as field studies provide opportunities for progress on several of the research questions. Cohen et al. (2008:190) also recognise this, stating the following:

“Field study methodologies (e.g. interviews) could offer significant opportunities in this area and have the potential for providing important insights... A field study involving interviews with auditors or audit committee members may provide significant insights on the extent of management influences on selection of members to the audit committee and its resulting impact on audit committees’ effectiveness in monitoring internal controls.”

Beasley et al. (2009:72), in their research on the audit committee oversight process, identify the need for audit committee research using the interview method to better understand audit committee activities and explore issues that are difficult to examine using archival methods. An example is provided in that archival research will provide insights into obvious threats to the objectivity of the audit committee member by referring to the employment history of the audit committee member. On the other hand, the interview method can expose subtle threats

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<sup>81</sup> Areas/questions include the mix of audit committee backgrounds that would best promote effectiveness: what the mix of competence should be, group variables for example interaction and teamwork, member dominance, team aspect and the need to explore organisational behavior and psychology and the ability to attract audit committee members.

to objectivity like personal friendships between management and the audit committee members that may not be revealed through archival methods.

Other research studies that also used in-depth interviews with individuals performing specific roles in relation to audit committees include studies by Spira (1999a and 1999b) and Cohen et al. (2017:1178).

The approach followed during this research was to use semi-structured interviews informed by broad themes rather than structured interviews. The purpose of structured interviewing is to capture precise data that will enable coding to be able to explain behaviour in pre-defined categories. Unstructured interviewing's purpose is to understand the complexity without imposing any prior categorisation that could limit information obtained (Fontana & Frey, 2000:653). It was decided to conduct semi-structured interviews to encourage interviewees to express themselves according to their own experiences of audit committees.

Like Gendron et al. (2004), an interview guide document was developed prior to the fieldwork that identified broad thematic areas to discuss ensuring there is enough flexibility to explore emerging themes during the interview. The interview guide was developed and informed by the research objectives and questions, the literature review, applicable legislation, recommended practices in corporate governance codes and the specific recommendations in the supplement for municipalities, guidance by professional bodies and regulators, and academic studies on effectiveness of audit committees. Additional themes based on own experience and intuition were incorporated in the interview instrument as the focus of the research was emerging. The interview guide was customised for each category of participant i.e. the mayor, MM, CAE, CFO and ACC. An example of the interview guide used for the MM is attached as Annexure 4.

The design method for the interviews and effectiveness determinants was also used by other researchers. Beasley et al. (2009:73) used the KPMG Audit Committee Institute's *Building a framework for effective audit committee oversight* to identify the six audit committee process areas and used prior experience working with auditors and audit committees, professional literature, academic literature, and discussions with audit committee members and standard setters to design the questions. Gendron and Bédard (2006:216) also made use of interviews in their study around the notion of audit committee effectiveness with the emphasis being on processes of self-understanding and understanding of others in constructing meanings around audit committee effectiveness.

During the structure of questions for the interviews, care was taken to avoid pitfalls highlighted by earlier related studies. Purcell (2012) assessed the Victorian local government against local government guidelines but identified the lack of measures in the guideline on how to establish if audit committees had achieved the outcomes and the absence of behavioural questions as a weakness of the document. Important aspects not included as part of the document identified were staffing (independence), style (way in which audit committee members and management achieve outcomes), skills (competencies, capabilities, and capacities), and shared values (organisational culture). He also used reviewed best practice guides and audit committee questionnaires to ensure it contained information that complemented academic research literature and identified any issues that could be included in the methodology and findings (Purcell, 2012:97-98). A similar approach was followed, and the following table sets out the broad thematic areas covered in the interview guide:

**Table 6.3: Broad thematic areas covered in interview guide**

Thematic area	Possible sub-areas
Assessment of authority	Charter; power; support; resources
Membership	Experience; expertise; independence; diligence; tenure
Appointment	Selection; acceptance and due diligence;
Role of the audit committee	Extent to which it fulfils its mandate. Oversight of financial reporting process. Oversight of external and internal audit. Internal control. Risk management. Compliance. Performance management. Ethics and code of conduct. Evaluation of AC.
Audit Committee Chair	Leadership.
Meetings and activities of the audit committee	Process of a typical meeting including number and length. Agenda. Information packet. Effectiveness through ceremonial features of a meeting. Effectiveness through reflective interpretations of the substance of meetings including skills in questioning and type of questions.
Informal practices and interactions	Between meetings. Issues addressed. Nature of informal interaction. Impact on effectiveness.
Interactions with management	Audit committee viewed either as positive or a nuisance. Management responsiveness to the audit committee.
Reporting from the audit committee to council	Useful and adequate.

The researcher solicited feedback on the broad thematic areas from several academic researchers and current audit committee members. The relevance, completeness, and clarity of themes were also discussed with individuals at the pilot site. At the pilot site, interviews were conducted with the mayor, MM, CAE, and CFO. This assisted in refining the interview themes and testing the relevance and comprehensiveness of topics discussed and the interview approach. As a result, the research guidance document and interview approach was amended based on feedback from the pilot testing. Although the pre-testing group were not part of the initial target population, the extent and richness of information provided during the interviews necessitated for the information to be included as part of the study.

Gaining trust is important to ensure the success of the interviews. During the interviews, notes were taken regularly without making it conspicuous including on participant body-language signs observed. A conscious effort was also made not to influence the interview in any way. After each interview the researcher reflected on the information obtained from the interview.

Several steps were followed to ensure reliability of the field study information. The study was introduced at the beginning of each interview by explaining the purpose of the study. Informed consent forms were completed and signed by both the interviewer and interviewee and it was emphasised that complete anonymity would be provided to the interviewees and their organisation. Where permitted, the interviews were audiotaped to ensure accuracy and completeness and were later transcribed. The interviewees were also informed that they would have the opportunity to subsequently verify the accuracy of the transcripts and add any changes they felt necessary. Reliability was also addressed by interviewing multiple participants. Throughout the interviews, the researcher also asked interviewees to provide examples to substantiate their thoughts. In the consent agreement, it was made clear that participants could withdraw at any time of the study.

### **6.5.2 Document analysis**

Before each interview, the website of the municipality was studied to obtain maximum information related to the activities of the AC. Of specific interest were the annual reports of the Municipality including the audit committee reports and the Auditor-General reports for the three most recent years. It is the general practice for audit committee reports to contain information on the membership of audit committees, the number of meetings held and attended, and major recommendations made by the AC.

The AC charters were obtained and where permitted by the municipality, the agendas and minutes of audit committee meetings and the audit committee reports to council were scrutinised. At some of the municipality's additional documentation were also provided. Already, while gathering data, the analysis commenced by identifying categories of effectiveness and matching it with the data through an interactive process. Particular and additional categories and areas of interest developed with additional interviews.

The information obtained provided a further understanding of the theoretical viewpoint that is most suited to understand audit committee effectiveness and to identify the factors enabling and/or restricting audit committees to be effective.

## 6.6 Ethical considerations

Stake (2000:447) makes the following statement:

“Qualitative researchers are guests in the private spaces of the world. Their manners should be good and their code of ethics strict.”

Tracy (2010) refers to a variety of practices related to ethics in qualitative research including procedural, situational, relational, and exiting ethics. Procedural ethics refer to universally accepted ethical practices including not being harmful, avoiding deception, obtaining informed consent, and ensuring privacy and confidentiality. Furthermore, it ensures that participants have the right to know the nature and potential consequences of the research and that participation is voluntary (Tracy, 2010:847). Procedural ethics were complied with during the research by obtaining the necessary approval of the research ethics committee of the University, providing the participants with a letter of consent explaining the research process, and obtaining participant approval. Confidentiality was ensured by securing all personal data in a locked office and all electronic information protected by way of password control. The name of the institution or persons that participated were protected by way of using codes instead of actual names.

Situational ethics is described by Ellis (2007:4) as dealing with ‘the unpredictable, often subtle, yet ethically important moments that come up in the field’. Situational ethics require of the researcher to continuously consider whether the methods used, and the data is worth exposing and ethical decisions should be based on the specific context (Tracy, 2010:847).

Relational ethics refers to the ethical self-consciousness in that the researcher considers their own character and actions and how this affects others. Relational ethics include an ethic of care that acknowledges and values mutual respect and dignity - like the meaning of the word Ubuntu<sup>82</sup> - between researchers, participants, and the communities (Ellis, 2007:4).

Exiting ethics refers to the ethical consideration continuing after data collection and include how the researcher shares the results to avoid unfair consequences (Tracy, 2010:847).

During this study, the researcher upheld ethics. Traditional ethical concerns include ensuring informed consent by the participants after being informed about the research and the right to privacy and protection from harm to which this research has complied. Throughout this research, the researcher reflected on any ethical conflicts within the specific municipality where the research was performed.

The participants were informed about the process and reporting, drafts of the transcriptions and relevant information reported and presented, quoted, and interpreted were provided to the participants to obtain their inputs and signs of concern.

## 6.7 Issues of trustworthiness

Lincoln and Guba (1985) discuss trustworthiness in four categories, namely truth value, applicability, consistency, and neutrality and relate it to the appropriateness thereof in the naturalistic paradigm. Truth value can be demonstrated by ensuring credibility. Credibility can be achieved by carrying out the inquiry in a way that the probability that the findings will be considered credible is enhanced and to demonstrate the credibility of the findings by ensuring it is approved by the participants. Applicability is discussed regarding the transferability, and in the context of the naturalistic paradigm, the original investigator's responsibility is to provide sufficient descriptive data to make it possible for anyone that seeks to accumulate empirical evidence about contextual similarities possible. Dependability is a substitution criterion for consistency in the naturalistic inquiry and the researcher will endeavour to consider factors of instability and those that result from a change in the design. Lastly, neutrality links to objectivity and naturalists promote the objectivity of the data rather than the objectivity of the researcher and the extent to which the data are confirmable (Lincoln & Guba, 1985:296-300). Credibility can be achieved through prolonged engagement, persistent observation, and triangulation.

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<sup>82</sup> *Ubuntu* or *Hunhu* is clearly expressed in the Nguni/Ndebele phrase: *umuntu ngumuntu ngngabantu* which means a person is a person through other persons and refers to the moral attribute of a person (Mangena).

Transferability can be addressed by a 'thick description' and providing the widest possible range of information necessary to enable transferability. Dependability and confirmability can be ensured by a thorough review of the process of inquiry and the quality of the data, findings, interpretations, and recommendations (Lincoln & Guba, 1985:301, 316-318).

Stake (2000:443) recommends that to reduce the likelihood of misinterpretation researchers must use different procedures, including using several observations to clarify meaning and through repeats, verifying observations or interpretations, referred to as triangulation.

One of the eight criteria for excellent qualitative research defined by Tracy (2010) includes credibility, which refers to the trustworthiness, reliability, and plausibility of the research findings. She explains for research results to be credible they need to make readers feel the information is trustworthy enough to act on and make decisions accordingly. Consistent with Lincoln and Guba (1985), Tracy (2010:843) states that qualitative credibility is achieved through rich descriptions, triangulation and multivocality, and members' reflections.

Rich descriptions means having abundant concrete detail and requires that the researcher can explain the complexity and circumstances in which the data was obtained (Bochner, 2000:270). The detail provided by the researcher needs to be enough to enable the reader to come to their own conclusion and not for the researcher to tell the reader what to think (Tracy, 2010:843). Concrete detail is necessary for the researcher to obtain implicit knowledge that is not always articulated but includes contextual understanding through body language, for example, nods, silences, and humour (Altheide & Johnson, 1994:492).

Triangulation in qualitative research is based on the assumption that a conclusion is more credible and addresses possible bias if it is supported through the use of a variety of data sources, multiple perspectives to interpret a single set of data, and using multiple methods to study a single problem (Janesick, 2000:391). Crystallisation also relates to using multiple data sources, researchers, and perspectives but assumes it is being done not to provide credibility to the research but rather to assist with a complex, in-depth understanding of the issue (Janesick, 2000:391-392; Tracy, 2010:844).

Multivocal research provides for multiple and varied voices in qualitative analysis and creates an opportunity for different opinions (Tracy, 2010:843). This research provides for this in including the various participants in the audit committee arena, namely the mayor, MM, CFO, CAE and ACC.



Members or participant reflections refers to obtaining the input of the participants during the process of analysing and producing the research results to allow for sharing and providing the opportunity for participants to question, critique, give feed-back, affirm, or even collaborate further towards the research results (Tracy, 2010:844). Lindlof and Taylor (2002:242) describe it as 'taking findings back to the field and determining whether the participants recognise them as true or accurate'. Not only do participation reflections serve to enhance the credibility of the information but they can also result in new data and an opportunity for collaboration. It also provides a sounding board for whether the participants find the research comprehensible and meaningful (Tracy, 2010:844).

Yin (2018:43) identifies four tests to evaluate the quality of case study research. Table 6.4 links the design tests to case study tactics to be used.

**Table 6.4: Case study tactics for four design tests**

Tests	Case study tactics
Construct validity. Identify appropriate operational (effectiveness) measures for the concepts being studied	use multiple sources of evidence have key informants review draft case study report
Internal validity: (Not for descriptive or exploratory studies) Seek to establish a causal relationship	do pattern matching do explanation building address rival explanations use logic methods
External validity: Showing if and how a case study's findings can be generalised	use theory in single case-studies use replication logic in multiple-case studies
Reliability: Demonstrate the procedures of the research for example data collection procedures can be repeated with the same results	use case study protocol develop case study database maintain a chain of evidence

(Yin, 2018:43)

In Chapter 7, the results of the research will be measured against the criteria of Yin and others to ensure compliance with the criteria of trustworthiness.

## 6.8 Limitations and delimitations

The literature review indicated that most of the studies on governance and audit committees tend to follow a quantitative rather than a qualitative approach. A possible criticism against this study includes selecting a qualitative rather than a quantitative approach. Using the method of case study has also been a topic of controversy in the academic debates, which

may be a limitation of this study. These possible limitations and other delimitations are discussed in this section.

The main criticism against the qualitative approach is the difficulty in interpreting performance and making comparisons, as well as the potential for self-reporting bias (Purcell, 2012:63). The reason for selecting a qualitative rather than a quantitative approach is discussed in section 6.2.1. The purpose of this research is to study audit committees in natural settings to get a holistic understanding of the complexities being experienced within the specific unique cultural and social context. As recognised by Patton (2015:36-37), this research aims to capture stories and understand people's perspectives and experience. It was considered necessary to explain how systems function and consequences and how and why it matters.

As set out above, due to the unique and complex environment of local government and the various factors impacting individual municipalities, following a quantitative approach would not have enabled me to achieve the research objectives and obtain answers to the research questions.

Much criticism has been raised against the case study research method and reasons why it has been considered a less desirable method compared to other methods. For this study, it is important to reflect on the appropriateness of the case study method to achieve the research objectives. It is appropriate, therefore, to analyse the arguments for and against the case study to substantiate the suitability of the case study method for the research. Flyvbjerg (2011:302-313) identifies five misunderstandings or conventional views on the case study and responds to it through detailed motivation, the summary being included in Table 6.5.

Historically, fierce critics of the case study method have over time altered their views of the case study method from being of no scientific value to them being acceptable to produce concrete-context knowledge. Eysenck that originally saw the case study method as producing narratives later recognised the value of case studies in not proving anything but learning something (Flyvbjerg, 2011:303). Researchers have also recognised and urged the need for fieldwork type methodologies, specifically in governance related research (Cohen et al., 2008:188).

As recognised in Flyvbjerg's (2011) work, one misunderstanding is that it is only appropriate for explanatory phases of the research and consists of a preliminary mode of inquiry and cannot be used to describe a phenomenon or test propositions. Yin (2018:7) argues against this criticism in that experiments with an exploratory motive have always existed and that

causal explanations has long been a serious concern and refers to many famous case studies that are explanatory case studies.

**Table 6.5: Misunderstandings of case study**

Misunderstanding	Description	Response by Flyvbjerg
Misunderstanding 1	'General, theoretical knowledge is more valuable than concrete case knowledge.'	'Predictive theories and universals cannot be found in the study of human affairs. Concrete case knowledge is therefore more valuable than the vain search for predictive theories and universals.'
Misunderstanding 2	'Generalisation is not possible on the basis of an individual case and therefore cannot contribute to scientific development.'	'One can often generalise on the basis of a single case study, and the case study may be central to scientific development via generalisation as supplement or alternative to other methods. But formal generalisation is overvalued as a source of scientific development whereas 'the force of example' and transferability are underestimated'.'
Misunderstanding 3	'The case study is most useful for generating hypotheses, while other methods are more suitable for hypothesis testing and theory building, research process and other methods are more suitable for testing hypotheses and building theory.'	'The case study is useful for both generating and testing of hypotheses but is not limited to those research activities alone.'
Misunderstanding 4	'Study contains a bias towards verification, that is, a tendency to confirm the researcher's preconceived notions.'	'The case study contains no greater bias toward verification of the researcher's preconceived notions than other methods of inquiry. On the contrary, experience indicates that the case study contains a greater bias towards falsification of preconceived notions than toward verification.'
Misunderstanding 5	'It is often difficult to summarise and develop general propositions on the basis of specific studies.'	'It is correct that summarizing case studies is often difficult, especially as concerns case process. It is less correct as regards case outcomes. The problems in summarizing case studies, however, are due more often to the properties of the reality studied than to the case as a research method. Often it is not desirable to summarise and generalise case studies. Good studies should be read as narratives in their entirety.'

(Flyvbjerg, 2011:302-313)

Other criticisms include the lack of rigour, the confusion with non-research case studies, the inability to generalise from case studies, the long time it takes, and massive unreadable documents it produces. All these factors may be a limitation. Rigour is addressed in sections 6.2.2 and 6.7.

On the inability to generalise based on the results of case studies, Carcello et al. (2011:19) state:

“Field studies are useful for providing very rich descriptive data but given the labor-intensive nature of the data-collection process, the sample sizes are small. As such, the generalizability of findings is always a potential concern.”

Various researchers have responded to the criticism of the inability to generalise. Tracy (2010:845), in her identification of criteria for excellent qualitative research, identifies one criterion to be resonance, describing it as the ability of the research to affect an audience and have impact. According to Tracy (2010), resonance can be achieved through aesthetic merit (present the text beautifully and artistically), naturalistic generalisation, and transferability. The concept of naturalistic generalisation has already been discussed by Lincoln and Guba in 1985, referring to the work of Stake (1985:120), and they explain naturalistic generalisation as through personal direct and indirect experience and sharing that by way of words and illustrations in a form the readers usually experience it to be an effective way of adding to the understanding for all readers. Case studies are a powerful means to achieve naturalistic generalisation. Tracy (2010:845) also recognises that qualitative researchers do not pursue resonance by the need to generalise across cases but rather within cases.

Yin (2018:38) also refers to it as analytic generalisation instead of statistical generalisation, where the purpose is to go beyond the setting of the specific case (s) to reflect on lessons learned from the case study and state the analytical generalisation as a claim by providing a supportive argument. The outcome of the analytic generalisation can result in greater insights about the how and why questions the researchers attempts to answer through the case study.

In this study, by interacting with the mayor, MM, CFO, internal audit, and ACC, the researcher was able to generalise based on the results within the specific municipality. Transferability is achieved if the readers feel as if the story of the research relates to their own situation and they intuitively transfer the research to their own actions (Tracy, 2010:845). The researcher hopes to achieve this in sharing the research results of this study.

## 6.9 Conclusion

Carcello et al. (2011:27), in their literature review and synthesis on governance-related literature focusing on corporate board and audit committee issues, conclude as follows:

“Some of the new avenues of research will...have to rely on experiments, field studies, and surveys. The latter two approaches in particular are viewed by some as less rigorous than archival, econometric-based research methods. However, as an academic discipline we have a fundamental choice to make. We can continue to rely predominantly on archival research methods, and to improving the rigor and elegance of these methods, which we apply to increasingly narrow questions. However, this strategy will cause us to leave some of the most interesting questions unexplored, and it almost guarantees a decline in how the practicing world views the relevance of our research. Alternatively, we can choose to expand the set of acceptable research approaches and, as a result, begin to better understand the issues that matter most to accountants, attorneys, practitioners, regulators, and investors. In our view, the choice is obvious if we wish to continue to contribute to the corporate governance field” (Carcello, 2011:27).

The researcher followed a new avenue in this research by moving away from the traditional agency theory being used in studies on audit committees to using multiple theories including agency, resource dependence, institutional and practice-orientated theory, as discussed in section 2.2.2. This research, while focusing on the more traditional research area of audit committees, examines it from a different sector and different economies by focussing on the public sector and specifically local government, an area where limited research has been completed, as argued in Chapter 1. I made use of a qualitative approach, using the case study research method and incorporated her story (autoethnography) through the presentation of the research.

The study always endeavoured to comply with the eight criteria for excellent qualitative research defined by Tracy (2010:839), namely a worthy topic, rich rigour, sincerity, credibility, resonance, significant contribution, ethics, and meaningful coherence. The results of this study show that it is a worthy topic in that it is relevant and timely and does not merely confirm existing assumptions, but rather introduces the readers to other important practices and praxis of audit committee practitioners. This is the first known case study that examines the effectiveness of audit committees within local government in South Africa using the case study methodology. It is also the first study to gather interview data from the key stakeholders involved with audit committees, including the ACC, the MM, the CFO, the mayor, and the CAE.

To comply with the criteria of rich rigour, the study used a variety of theoretical constructs, data sources, contexts, and samples to generate rich, thick, and multi-layered data. Sincerity, according to Tracy (2010:839), is demonstrated by the study being characterised by self-reflexivity about subjective values, biases, and the transparency about the methods and

challenges used during the study. Bringing in the elements of autoethnography and writing the narrative encouraged the researcher to be self-reflexive and critically evaluate the practice, practitioners, and praxis. The researcher presented the information transparently by sharing the challenges and mistakes during the research process as well as during serving on ACs' life. The researcher maintained an 'audit trail' with complete documentation about the research decisions and activities. Through the narratives, the researcher intend to create resonance and make a significant contribution to the scientific knowledge on audit committees in local government.

## CHAPTER SEVEN: RESEARCH RESULTS

### 7.1 Introduction

This chapter aims to describe the results of the empirical study and includes a summary and analysis of the research findings. The main objective of this study was to research the determinants of effective audit committees (AC) in local government by providing detailed insights into the AC practices, practitioners, and praxis as perceived by the different stakeholders. The research findings were informed by an analysis of municipal documentation including publicly available documents and those provided during the fieldwork. Valuable information was obtained during interviews with various stakeholders that deal with or are supposed to interact with ACs. The participants' stories, experiences, and perceptions related to ACs are shared in this chapter. This chapter closes the loop between the research questions and objectives, the literature review, and the findings of the study on practice, practitioners, and praxis that are associated with effective ACs in South African local government.

Throughout this chapter *Fieldwork praxis tips* are indicated. These are praxis participants indicated working well in their environment and would not necessarily be relevant or useful at all municipalities.

### 7.2 General overview of the participating municipalities

The participating municipalities included three municipalities from the Northern Cape (two municipalities and one district municipality) and four from the Western Cape (three municipalities and one district municipality). The reason for the additional municipality from the Western Cape compared to the Northern Cape is as a result of the pilot study being performed in the Western Cape. Due to the richness of the information obtained during the pilot study it was decided to also include the information from the pilot study as part of the results of the research. The following table shows a high-level view of the external audit results of the municipalities and demonstrates possible governance challenges.



**Table 7.1: Summary of AGSA opinion for fieldwork cases**

	Unqualified with no findings			Unqualified with findings			Qualified with findings		
	2018	2017	2016	2018	2017	2016	2018	2017	2016
MUN1	√	√	√						
MUN2				√	√	√			
MUN3							√	N1	√
MUN4	√	√	√						
MUN5	√	√	√						
MUN6	√	√	√						
MUN7		√	√	√					

N1- Not finalised at legislated date

In the audit outcome reports, the AGSA distinguishes between financial statement qualification areas, predetermined objectives (non-financial information) findings, findings on compliance, findings on specific risk areas and the extent of unauthorised, irregular, and fruitless and wasteful expenditure. Despite the positive opinions in some of the municipalities indicated in Table 7.1 above, the AGSA still highlighted findings at these municipalities on specific risk areas including quality of performance reports submitted, financial health, information technology, supply chain management, and human resource management. The AGSA further indicated unauthorised, irregular, or fruitless and wasteful expenditure at each of the municipalities that formed part of the sample and non-compliance with legislation.

In accordance with the philosophy behind qualitative studies it was considered necessary to explore in detail the practice, practitioners, and praxis of effective ACs as part of the governance process. The next section presents the results of the interactions with the circle of role-players that affect or are affected by the AC to better understand perceived AC effectiveness and what informs it.

## 7.3 Participants and their stories

### 7.3.1 Participants

For this research and based on legislative and other requirements (Chapter 4) as well as the literature review (Chapter 2), the participants that deal with the AC or who have an interest in the activities and results of AC activities were identified to include the council (governing body), MM, CFO, CAE, and EA. As previously indicated, it was not possible to secure discussions with members of the AGSA involved with the cases of this study and alternative procedures

were performed described in section 6.5.2. The ACC was also identified as a key role-player representing the AC and playing an important part in the interaction between the various role-players. Chapter 3 of this study (section 3.3) describes the different role-players and the interaction with the AC in more detail. The AC is a sub-committee of council with the result that the council should take an interest in the work and results of the activities performed by the AC. The representative of council was identified as the mayor and was selected as one of the participants of this study. In cases where it was not possible to access the mayor, efforts were made to access one of the council members that also deals with the AC, for example a member of the council portfolio committee of finance or the speaker. The accounting officer or, in the context of local government the MM, was identified as another necessary participant in this study. For this research, the MM was identified as the participant to represent the rest of the executive managers. However, due to the nature and focus of the AC on the financial information of the municipality, it was considered important to have separate interactions with the CFO being accountable for the financial management at the municipality. The AC also plays a critical role in overseeing internal audit and the CAE as representative of the IAF was selected as a participant.

### **7.3.2 Method**

The data for construction and analysis of the case study was gathered from three sources: semi-structured interviews with stakeholders affected by the AC activities, publicly available information including annual reports and AC reports, and internal documents made available.

The data was mostly gathered through the interviews, which is considered appropriate for this research, due to one of the objectives being to determine whether there is a gap between what is required of ACs in terms of legislation and best practice and the expectations of stakeholders. Interviews also provided the opportunity to gain insights as it explored issues that would not necessarily have come to the fore with archival studies. During the interviews, reliance was placed on an interview guide that was developed prior to the fieldwork and that was based on the research objectives, literature review, and own experience. The use of the interview guide assisted in directing the discussion and making the data collection systematic while being flexible and without limiting the free flow of information sharing, keeping it contextual and allowing for emerging issues to be raised. The relevance, completeness, and clarity of the interview guide were tested during the pilot study with the different categories of participants. The range of stakeholders interviewed included the ACC, mayor or council representative, MM, CAE, and CFO. The interview guide was customised for each category

of interviewees and the approach followed allowed the participants to express themselves within their own municipal context.

Several steps were taken to ensure the reliability of the field evidence. Firstly, before the interview, letters that explained the research and informed consent forms were distributed to the participants. At the start of the interview the objectives of the research were explained, and the informed consent form signed by both the researcher and the interviewer before the different themes were discussed. To mitigate the possible reluctance to provide information freely, permission was asked to record the interview and complete anonymity for the individual as well as the organisation were emphasised. The researcher also informed the participant that an opportunity would be provided to verify the accuracy of the transcripts and provide any changes the participant might consider necessary to make them more comfortable with what they said during the interview. Secondly, fieldwork evidence was obtained from multiple participants in each municipality. Thirdly, where considered necessary the interviewees were asked for examples to substantiate their thoughts. Finally, some of the participants, on their own initiative, also referred to experiences with other ACs they are involved with, and where challenges for effectiveness were experienced creating the perception, they were not biased about overstating the effectiveness of the ACs. Through the use of multiple and variety sources of data - including interview data supplemented by archival data obtained including the annual reports, AC reports, AC charters, agenda and minutes of AC meetings and AGSA reports and additional information provided by participants - and multiple perspectives within a municipality, credibility and reliability was achieved through triangulation.

Of the total, 19 interviews were recorded, and for the rest of the interviews detailed interview notes were compiled. The average time of the interviews was 45 minutes. The duration of interviews was longer when the ACC, CAE and MM were interviewed and shorter when interviews were conducted with the mayor or representative of council. This is to be expected due to the importance and extent of the interaction between the AC and the CAE, also discussed in section 4.8 and the MM being the party ultimately responsible and accountable for the management of the municipality. Most of the interviews were face-to-face apart from one case where a telephonic interview was conducted. Interviews were mostly conducted at the municipal offices and for the interviews with the respective ACCs at their homes. Most of the data were collected during 2019, with some interviews concluded early in 2020. Table 7.2 sets out the number of different categories of role-players interviewed.

**Table 7.2: Number of interviewees per category of role-player**

Category of participant	Number
Mayor/representative	7
Municipal Manager	7
Chief Financial Officer	4
Chief Audit Executive	6
Audit Committee Chair	5
<b>Total Interviews</b>	<b>29</b>

The researcher was unable to secure interviews with all CFOs, despite concerted efforts, mainly as a result of unavailability due to work pressures including the annual audit, annual budget, and annual reporting processes. The inability to conduct interviews with all ACC is mostly as a result of the chairpersons not living or working in close proximity of the municipality – one of the challenges on recruiting effective AC members at rural municipalities (see section 7.4.2.1).

Sample size in qualitative research has been a hotly debated topic, however, the guiding principle is the concept of saturation. Mason (2010:1, 16) specifically studied sample size and saturation in PhD studies using qualitative interviews. Based on an analysis of 560 PhD studies the results showed that the mean sample was 31 with the most common sample sizes being 20 and 30. However, the researcher emphasises saturation, although not the only way to do qualitative studies, should be the guiding principle for qualitative data collection. Qualitative research focus on meaning rather than making generalised hypothesis and the sample is usually much smaller. Mason (2010:1) states that with qualitative studies there is a point of diminishing return, even if the study continues more data will not necessarily lead to more information. With this research it is the researcher's view that most of the perceptions that were important was uncovered and the collection of additional data on practice, practitioners, and praxis of ACs would not shed further light on the research area. Researchers have further suggested that expertise in a chosen topic can reduce the number of participants needed in a study (Mason, 2010:2). The researcher's own experience is shared throughout the study and, together with the information obtained through interviews and document analysis, the point of saturation was achieved.

During the interviews, field notes and general observations were documented. After the interviews, the field notes were used to populate an initial matrix by arranging the data per municipality, per category of interviewee, per main theme, for easy viewing. Once transcripts were obtained the initial matrixes were expanded to include additional information and higher-level explanations. Transcripts were also used to select data pieces and direct quotes to be

included in this chapter. During the selection process, 'decision rules' were documented as recommended by Miles, Huberman and Saldaña (2014:116). The interview transcripts were analysed using qualitative procedures (Miles et al., 2014). A coding scheme was developed while reading the transcripts to enhance data sensitivity. Significant words or phrases were first highlighted in a few transcripts to develop a coding scheme. This scheme was then used to code the other transcripts. In addition, for each municipality a conceptual matrix was prepared in which the main themes resulting from the discussion with the participants were captured and summarised in the table that gave a good basis for comparing the different views within the same municipality to ensure the views converge. The analysis provided insights into the views of the roles and responsibilities, the effectiveness, challenges, and value added by the AC.

Yin's (2018) requirements for quality of case studies including constructing validity and reliability (section 6.7) were complied with during this fieldwork. Multiple sources of evidence were used, the participants were given the opportunity to review the draft chapter, case study protocols were followed, and a case study database and portfolio of evidence were maintained.

The information discussed in the main analysis of this research includes field evidence of the practice, practitioners and praxis associated with effective ACs. Adopting this focus the analysis of the case study is structured around the following interrelated and not mutually excluded dimensions that affects the operations of the AC: mandate and authority, composition and appointment, roles and responsibilities, formal and informal meetings, interactions and activities, communication including reporting, and the overall perceived effectiveness of ACs. Each of these dimensions' areas are elaborated on in the remaining sections of this chapter.

## **7.4 Results**

The first dimension that affects the operations of the AC is the mandate and authority that is discussed in subsection 7.4.1.

### 7.4.1 Mandate and authority of the audit committee

Identifying the ultimate source of the AC authority and the association between the effectiveness of ACs and AC authority have been the subject of research on ACs. Within the local government environment, various parties play a role in the governance of the municipality and as part of this research it is important to establish the mandate and authority of the AC. Under the thematic area, mandate, and authority of ACs, the sub-themes that emerged and were explored during the discussions and presented in this subsection include the AC charter, advisory versus oversight role, power and authority of the AC and what influences it, relationships, and support and resources provided to the AC.

Under the next heading information on the analysis of the AC charters for the cases in this research is explored.

#### *7.4.1.1 Analysis of Audit Committee Charters*

One of the earlier challenges for South African public sector ACs identified is unclear accountability, role clarity, and reporting lines and that AC charters do not clearly define the requirements of the AC in relation to the entity's environment (IODSA, 2014a: 7-9).

During the fieldwork, the importance of the AC charter was evident in that at 100% of the municipalities reference was made to the AC charter providing the necessary authority to the AC when approved by council. Except for one, all of the municipalities visited provided copies of their AC charters.

Section 4.5 discussed the importance of the AC charter for effective ACs in providing the AC with the necessary authority. To the extent that the governing body delegates certain functions to the AC, it is required that delegation to ACs, roles and responsibilities, membership requirements, and procedural conduct should be documented in a formal AC charter that should be annually reviewed and updated to ensure relevance and consistency with legislative requirements and best practice and be approved by the governing body. Circular 65 further recommends that after approval, the AC charter should be published on the municipal website to promote awareness among stakeholders (National Treasury, 2012:3).

The IIA (2014:5) describes elements to be included in the AC charter to include the mandate, membership requirements, authority and responsibilities and process for developing,

reviewing, and updating the charter. The charter should also address the key concept of independence. In the Model Audit Committee Charter issued by the IIA a distinction is made between optional content and compulsory content. Compulsory content includes the purpose, authority, composition, ACC, and term of office (IIA, 2017).

The important elements to be included in the AC charter were compiled by referring to the research presented in chapters 4 and 5 and are reflected in Table 7.3 below. The actual charters of the ACs that were obtained during the fieldwork were compared to the elements identified through the research and the results are included in Table 7.3.

**Table 7.3: Analysis of AC Charters of cases**

Criteria/ Municipality	MUN1	MUN2	MUN4	MUN5	MUN6	MUN7
Purpose/ objectives	√	√	√	√	√	√
Authority (enquiries and access)	√	√	√	√	√	√
Roles and responsibilities/ methodology	√	√	√	√	√	√
Composition/membership and independence	√	√	√	√	√	√
Qualifications/experience	√	√	√	√	√	√
Term	√	√	√	√	√	√
Performance assessment	√	√	x	√	√	√
Appointment	√	√	√	√	√	√
Procedural conduct confidentiality	√	√	√	√	√	√
Relationship with other stakeholders	√	√	√	√	√	√
Ethical requirements	x	√	x	√	√	√
Reporting	√	√	√	√	√	√
Remuneration	√	√	x	√	√	√
Induction/training	x	x	x	√	√	√
Review and update of Charter	√	√	√	√	√	√
Published on website	x	x	x	x	x	x

Two areas recommended in best practice and research to be included in AC charters but not included in any of the AC charters of the cases are 'timetables' and 'liability of audit committee members'. Not reflecting timetables in the AC charter is not considered to be a major shortcoming as the ACs had work plans or detailed schedules and agendas built around target dates. However, the omission of a statement regarding the liability of AC members and the impact thereof need to be considered (also refer to section 4.19).

The deductions that can be made from Table 7.3 and based on the review of the charters are as follows: All AC charters included a purpose statement that was aligned to the AC requirements of the MFMA. The authority to discharge its responsibilities, per the charters,



was provided by having access to municipal records and other information and the ability to request relevant people to attend meetings and provide information required to perform their duties. Further, they have the authority to conduct investigations into the financial affairs of the municipality as requested by council. The charter of MUN4 authorised the AC to investigate projects as requested by the executive mayor, executive mayoral committee, and council. MUN5 was the only case where under 'authority' provision was made for the AC to resolve any disagreements between management and the external auditor regarding financial reporting.

MUN4, MUN5, and MUN7 had specific paragraphs in the AC charter that prohibited the AC from performing any management functions or assume management responsibilities.

MUN4, MUN5, MUN6, and MUN7 under authority provided for the AC to seek information or obtain professional advice from external parties subjected to normal tender and procurement procedures.

All AC charters reviewed complied with the compulsory requirements identified by the IIA in the Model Audit Committee Charter (IIA, 2017). The Model Audit Committee Charter distinguished between organisational principles, operational principles, operational procedures and oversight of the internal audit activity, and other assurance providers (IIA, 2017). Under authority, the Model Charter includes the following specific statement that was not observed in any of the reviewed AC charters:

If access to requested documents is denied due to legal or confidentiality reasons, the Audit Committee and/or CAE will follow a prescribed, board [council] approved mechanism for resolution of the matter.

All but one municipality included a statement on performance assessments of the AC (see discussion under the heading performance evaluations). The roles and responsibilities of the AC consistently reflected in all the AC charters reviewed include external audit, financial statements, internal audit, performance management, and ICT governance.

### **Fieldwork praxis tips**

#### **Audit Committee Charter**

- Include statement on AC liability.
- Include recourse when access is denied.
- Publish AC charter on website.

### **Concluding observations – AC Charters**

Approved AC Charters provide the necessary authority to the AC. In general, the AC charters of the cases, including those with favourable and less favourable audit outcomes, complied with requirements and best practice identified through research. Municipalities should consider publishing AC Charters on the municipal website to promote awareness among stakeholders.

However, as recognised by Purcell (2012:79), effective ACs go beyond just meeting the criteria set out in the AC charter and include successfully supporting the governing body to fulfil its responsibility. Other determinants that impact on successful support have been considered as part of this research. As part of role clarification, it was considered necessary to establish what the views of the participants were on advisory versus oversight role, if any, and the results are presented under the heading of 'Advisory versus oversight role'.

#### *7.4.1.2 Advisory versus oversight role*

Role clarity, especially the difference between advisory and oversight role and the application in practice, has been identified as an area to be further explored as part of this research. In Chapter 4, researchers' views on the differences between monitoring, oversight and advisory were discussed. Oversight, in this context, means that the AC acts on behalf of the council to

oversee certain management functions without being able to take direct action but being able to get results or influence actions. Advisory means to offer advice and recommend.

During the discussions, the views of the participants on whether the AC plays an advisory or an oversight role and if there is a difference between the two were solicited. The majority of the participants (68%) were of the view that the AC played both, 20% were of the view that it played an advisory role, and 12% an oversight role.

The following quote by the CAE at one of the municipalities describes how recommendations by the AC, without them taking direct action, can influence actions.

*[We take the whole audit committee report to the council as recommendations. There has not been a single instance that I can recall that the council did not accept the recommendations of the audit committee. That is why in many instances I do not refer to it as audit committee recommendations anymore. I tell the departments this was a council decision, why did you not implement the council decision].*

At the same municipality, the ACC was also of the view that the advisory role of the AC is very important due to the AC not making decisions but the council being the decision-making body.

He stated:

*[The council is very accommodating in the sense that they listen to the audit committee, although they do not always implement it. At least you know you could have influenced the decision they take at the end of the day].*

This is confirmed by a participant at a different municipality:

*I think there's a definite difference between advisory and oversight. Sometimes you can look at the two from the same lens, but I think just in terms of my view is that they must play the advisory role. They need to advise myself and council on issues relating to anything, finances, and HR anything within the operation of the municipality that they think we would need advice on. Or if they think the thing is not running the way it should be running and all of that. So, the advisory role should be there. In terms of oversight they can have an effect on the council's oversight role over administration and municipality just in terms of advising council. It's a fine line but overall, it should be advisory, and council should play the oversight role as they are mandated to do.*

The advisory role of the AC was also reflected in the AC charters that in all cases referred to the AC advising or assisting council to fulfil its responsibilities.

A consistent theme that emerged as part of the advisory role is the positive impact ACs had on the external audit outcomes and was expressed in five of the seven cases in this research. Some commentary in this regard:

MUN2: *[The role that they play is oversight and advisory and they are intimately involved with the council, intimately involved with the internal audit so they interrogate us, the municipality thoroughly. I can also mention in the previous year we moved from a situation with the audit committee of a qualified audit to a situation where we basically had a clean audit except for one finding. So, they are a functional, active audit committee. ... so, they supervise in a way and also monitor].*

At the same municipality, the representative of the council also expressed her and the council's satisfaction with the advisory role and resultant positive audit outcomes due to the role the AC play. *[If they did not play that role .. our audit outcomes would not have been so good. ... they really keep us on our toes not to do things we are not supposed to do.]*

At MUN1 the MM made mention of the AC's contribution to take the municipality from disclaimer opinions to clean audit opinions.

At MUN5, the mayor made the following statement:

*[We don't see them as policemen, we see them as a body that has been appointed to assist us in ensuring that what is done is done correctly. Hence having seven clean audits in a row.]*

However, the importance of the ACs' role in external audit outcomes was not only shared by management and the representatives of the governing body but also by some of the ACCs. For example, the ACC at MUN2 said he made it a personal goal for the municipality to achieve a clean audit opinion.

The research finding on the positive impact ACs had on external audit outcomes is corroborated by the AGSA in the 2015 report, and reflected in Table 3.3.

At one well-resourced municipality, one participant expressed that the AC plays an oversight role rather than an advisory role as it was considered that the municipality has all the necessary in-house expertise and does not really need the AC to play an advisory role. However, this was not the case in the smaller, more rural municipalities.

Another variable identified during the research that impacts on whether the AC plays more of an advisory role includes the competency of the AC members and the ACC as evident in the following observations from participants at MUN4.

*[Oversight is one thing, but I think if you have enough competent people on the team, especially with the chairperson taking the lead for the audit committee you can weigh heavier on the advisory side. We are very lucky at this point in time in that we have a very competent chairperson and a very competent team with a lot of experience on different levels. ... so definitely oversight but definitely advisory also. I think it is dependent on the municipality and the audit committee that you appoint. Depending on who you appoint on the audit committee will determine the type of role].*

At the same municipality, another respondent stated the quality of the AC determines the advice given and in their case the experience of members serving on other local government ACs contribute to the ability to provide advice.

### **Concluding observations – Advisory versus oversight role**

With reference to role clarity no uncertainty featured in the distinction between advisory and oversight role. Based on observations the role of the AC could differ depending on the circumstances at the municipality. Municipalities with sufficient own expertise would not necessarily rely on the AC to provide advice but smaller, more rural municipalities experienced greater value-add especially in the area of positive external audit outcomes. To use the terminology of Brennan and Kirwan (2015:476), whether the AC is a blamist tool or supportive of improvement, for this research supportive of improvement was clearly experienced by stakeholders.

Cases were identified where the AC made recommendations that were not always implemented by management or council contributing to less favourable audit outcomes. Due to the legislative mandate of the AC, being advisory, recommendations by the AC is not enforceable.

The views of the participants on the power and authority of the AC and the factors that impact thereon are further explored under the heading 'Power and authority of the audit committee'.

#### 7.4.1.3 Power and authority of the audit committee

Based on previous research, AC power can be achieved through, *inter alia*, adequate written authority, observable institutional support including the working relationship between the various role-players, demonstration of expertise in knowledge and experience, personalities, demonstration of leadership qualities by AC members and the ACC and the perceived commitment and diligence of the members and the ACC (DeZoort, et al. 2002; Kalbers & Fogarty, 1993 and 1998; Rittenberg & Nair, 1993; Turley & Zaman, 2007). From a personal attributes point of view, diligence by the AC was the most important source of power according to Kalbers and Fogarty (1993:24), which is discussed under the heading ‘Diligence’.

Adequate written authority by way of the AC charter and importance thereof has been dealt with under the heading ‘Analysis of AC charters’. For all the cases in this research, participants agreed that authority is provided to the AC through the AC charter and by providing unrestricted access to information and people required to fulfil their responsibilities. The ACC at one of the municipalities indicated that if any of these authorities are restricted he would immediately resign as an AC member.

The other variables identified in research on power and authority of the AC include institutional support (refer to the discussion under the heading ‘Audit committee support and resources’), the working relationship between the various role-players (refer to the discussion under the heading ‘Relationships’), experience and expertise (refer to the discussion under the heading ‘Experience and expertise of audit committee members’), personalities and leadership qualities (refer to the discussion under the heading ‘Characteristics of members and chairperson’), and commitment and diligence (refer to the discussion under the heading ‘Diligence’).

Participants were also of the opinion that power and authority of the AC are demonstrated by the extent to which AC recommendations are acted upon and responded to (MUN1 – MM; MUN6 – mayor; MUN7 MM, CAE, and mayor). The CFO and CAE at MUN2 referred to the AC recommendations being made to council that endorses it and which become council decisions that are then enforceable. This is agreed to by the AGSA that concluded that governance of municipalities was significantly improved by well-functioning audit committees and where councils and management implemented the recommendations of audit committees (2016:18).

The CFO at MUN7 explains that authority is demonstrated by management taking inputs from the AC seriously and puts in extra effort to implement recommendations. This can be observed in the detailed feed-back the CFO provides to queries raised by the AC. He believes that legitimacy is strongly linked to the AC's role and how it is reacted on by management:

Participants were of the opinion the culture at the municipality also plays a role.

*Where there is a performance culture it happens, otherwise not. (MUN7 – CFO).*

This was agreed to by the CAE at the same municipality:

*In this municipality the audit committee has authority because the culture of management gives it the authority.*

The MM at MUN1 agree that the culture and willingness of management to implement AC recommendations provide the power:

*[You must be prepared to listen to the audit committee. But if the audit committee warns and the administration just continues, who is to blame?]*

The same MM shared an experience at another municipality he was involved with where the opposite culture existed that resulted in weak governance.

The CFO at MUN2 reacted to the discussion on authority by stating:

*[I think it is the culture. For example, the external audit just finished now, and the general feeling is that if the actions recommended by the audit committee were implemented timely we would not have had some of the audit findings].*

Related to clarity of roles and power and authority, some of the participants (one mayor, two different MMs, and a CAE) felt very strongly that the AC should not interfere with management at the municipality. At two of the municipalities, the mayors re-iterated the role of the AC is not to manage the municipality and the AC needs to understand their role and that they cannot enforce recommendations. The one mayor also felt strongly that there is already too much power at different places within the municipality to the detriment of service delivery. He compared this to having two captains, the mayor, and the MM, and providing the AC with additional authority would not be beneficial.

A similar sentiment was expressed by an MM at another municipality that referred to the oversight role of the mayor, the council and MPAC and it sometimes feels that you are serving



two masters – MPAC and the AC – but seeing that it is a legislative requirement the municipality has to comply with it. He raised the following comment on multiple powers:

*[All our items first go through the ward committees, then the portfolio committees (where councillors serve on), so they are already exposed to the issues, that then goes to the Mayoral Committee and then eventually to the council. So, we are really not only dependent on the audit committee for oversight. There are a lot of structures that we follow.]*

The same MM expressed his view more than once during the meeting that the AC should not interfere with management. He related two examples where the AC wanted to interfere with management on a human resource related matter and on a special investigation required to be done by the internal audit that was, in his opinion, totally outside the mandate of the AC.

Another example of attempted interference with management was given by another MM at a different municipality where he had to phone the ACC where he felt it was a direct intervention, outside the mandate and authority of the ACC.

*[I said I do not think you should become involved. Leave it to me to get directly involved. I will deal with it on that level and he understood it as such.]*

The CAE at MUN6 stated the following regarding interference:

*You get chairpersons who wants to do the financial statements for you, who wants to run your audit planning for you. That's not their job. Their job is to see if governance is working.*

Research on ACs recognises the importance of relationships between the AC and the governing body, management, other committees, internal and external audit, and the extent to which it improves governance processes (further explored under the heading 'Relationships'). The next section presents the views of the participants and results of document analysis on these relationships.

### Fieldwork praxis tips

- Audit Committee Charter should include statement on no management interference.

### Concluding observations – Power and authority of AC

The fieldwork indicated that in addition to the AC charter, power and authority of the AC is determined by the culture of the municipality and demonstrated by the extent to which AC recommendations are implemented. Factors that can be grouped under organisational culture include institutional support, working relationships, and personalities that are further discussed in this chapter. The individual characteristics of AC members and ACCs and their diligence and commitment also impacts on power and authority.

Power and authority to discharge their responsibilities are further provided by having access to municipal records and other information and the ability to request relevant persons to attend meetings and provide information.

It was not possible through this research to demonstrate a direct link between power and authority of the AC and audit outcomes. However, through discussions it was observed at municipalities, that do not always take the AC seriously and implement AC recommendations the extent of AGSA material and unfavourable findings were more than at those municipalities with a perceived positive attitude towards implementing AC recommendations.

#### 7.4.1.4 Relationships

The Auditor-General stated the success of ACs in fulfilling their responsibility depends on a working relationship with the other governance role-players (AGSA, 2013:12). This section presents the findings of the research on the relationship between the AC and the council, AC and management, the AC and internal audit, and the AC and the AGSA. The importance of constructive relationships at the municipalities were identified by various participants. This section starts by presenting the views of participants on the importance of working relationships between the various parties and then hones in on the relationship between the

AC and ACC and council, management, IAF and EA. A common theme throughout the discussions was the need for an open relationship where the role-players are honest with each other.

On the importance of working relationships between all role-players, the MM at MUN4 explained the importance of establishing and maintaining relationships through involvement, in this case using the strategic planning session as an example:

*... most municipalities only invite the governing party to the strategic review and I said from the beginning I had the full support of the leadership here, we want all councillors including the opposition, we want to hear their view, we want to include you. Just paid huge dividends the constructive relationships. The second thing is I invited the chairman of the audit committee to come and sit in that. ... and I'm doing that in openness to say don't keep the auditors [audit committee] out there, let them come in and give them a perspective of what we're going to do. Let them come and hear it, let them hear what the councillors like, don't like, where the risk areas are ... So, you take out the mistrust and [the audit committee chair] will pick up gaps, make notes of it, follow it up and we want him to do that.*

At MUN1 the CAE also alluded to the authority of the AC originating from regular meetings with management and the political side of the municipality where the AC advises the mayor, management, and senior management. Management and the political parties listen to the advice from the AC and provide support.

*[They {management and political parties} will always refer to the recommendations the audit committee made. They always try and implement it and it is not that they only mention it and then leave it. We as internal audit keep track of the resolutions made by the audit committee and report quarterly to the audit committee on the implementation of the recommendations].*

The MM at MUN1 also felt very strongly about the importance of the relationships for good governance and related it to experience at other municipalities where in cases where there were good working relationships between the AC, IAF and management it made for strong governance but if not the governance is poor. He also acknowledged that without support of the municipality the AC will not be able to operate.

The MM at MUN2 believes that the relationship between the various role-players and specifically the way the AC presents itself will influence the co-operation they get from the municipality.

*[You know you get people that are very authoritarian and then you get people that can create an environment of co-operation and that can convince people to do the right thing. Our audit committee is successful in achieving that without being too authoritarian. The co-operation is good because the audit committee creates an environment for us to become involved. They do not create the image that they are here to get us where they can, but rather assist where they can for the municipality and for governance].*

The council representative at MUN6 also viewed that the authority of the AC is as a result of the good working relationship between the AC and various role-players, the competence of the AC (especially the ACC), and the willingness of the council to listen and implement recommendations. This was confirmed by the MM at MUN6:

*We take the audit committee very seriously because we see them as a committee that can meaningfully contribute towards the municipality but also making sure they do have the authority to play the role of ensuring that good governance happens at the municipality.*

Similar sentiments were expressed by the mayor at MUN7, who viewed support to the AC being demonstrated through the advice given by the AC being implemented. However, he emphasised that for that to work, there needs to be a good working relationship between the various parties.

The AC charters of MUN5 and MUN6 list the various stakeholders the AC need to maintain a good relationship with including the council, MPAC, portfolio committees of Finance and Management Services, MM, management and officials, internal and external auditors, and provincial and national treasury. The charter of MUN6 also refers to the broader community.

Honing on specific relationships, the first is between the important relationship between the council and/or the mayor and the AC. The importance of the relationship between the AC, being a sub-committee of council, was recognised during the fieldwork at all the municipalities (MUN1 – MM; MUN2 – council representative; MUN3 – Mayor; MUN4 – Mayor; MUN5 – MM; MUN 6 – council representative; MUN7- Mayor). To further investigate the practices and praxis, participants were encouraged to reflect on the council's understanding of the role of the AC and the relationship between the AC and council. Where relevant, sections of the AC charter and information in the annual reports and the AC reports were scrutinised for additional information on this relationship.

At several municipalities, the view was expressed that the councillors understand the role of the AC. At MUN1, the mayor stated that the councillors understand the role of the AC because the council need to authorise matters and before the councillors would authorise matters relating to the AC they would first consider what is presented to them. The AC charter at MUN1 also provides for the ACC to liaise directly with the mayor, speaker, and MM on matters of urgency and to make the council aware of matters that may significantly impact on the financial condition or affairs of the municipality.

At MUN2 the representative of council indicated the relationship is of such a nature that the ACC or AC members approach the mayor or speaker confidently if they would like to discuss a matter and the mayor or speaker would then make arrangements for this discussion. The council representative and the CAE at MUN2 indicated that at the council meetings where the AC minutes and recommendations are discussed, and if invited by council attended by one of the AC members, councillors will ask questions indicating that they studied the documentation and understand the role of the AC.

The mayor at MUN3 said the AC makes recommendations to the council and attends the council meetings once a year where they present their findings and recommendations to the council.

The mayor at MUN4 makes it his job to ensure the council understands the role of the AC.  
*[I know how important it is that you involve your councillors. They must know exactly what external audit {audit committee} is, how does the internal audit team look like and what they do and how important it is]*

The charter at MUN4 also states the Executive Mayoral Committee and the AC shall maintain a professional working relationship that is characterised by an open channel of communication.

The CAE at MUN6 referred to the trust the councillors place in the AC to such an extent that they take further action:

*... in some of those resolutions the council has actually referred some of those items to the MPAC and say please have a look at this. This looks a bit problematic, have a look at it. They do put a lot of trust in our audit committees, again because of their abilities.*

At certain municipalities, the view was that the council does not really understand the role the AC play or the value they add. It was also the view that councillors were not actively engaging

with or interrogating information received from the AC (MUN6 – MM, CAE; MUN7 – mayor, confirmed by CFO). Various possible reasons for this were provided.

The motivation for the perceived lack of understanding of the role includes that council merely accepts the AC report and minutes. As a result of the mayor's involvement and attendance of AC meetings, the councillors may believe that the mayor is aware of what happens at the AC and will inform the council if considered necessary and they need not concern themselves with it.

Recommendations were made to improve the understanding by councillors including providing visual presentations to highlight certain key matters that are simple and to the point. According to participants, if only the report and minutes are provided the information is too lengthy and not read by council. Another recommendation was to have a smaller workshop with the Mayoral Committee to inform them about possible shortcomings. At one of the municipalities that formed part of this study, the ACC meets with the MAYCO twice a year to provide detailed feed-back. This practice was considered beneficial by the representative of council.

However, what became very evident during the fieldwork is the important role the mayor plays in this relationship between council and the AC. At MUN1, MUN5, and MUN7 the mayor attends the AC meetings and/or meets with the ACC after the meeting. At MUN5, the portfolio committee members of Finance and Corporate Services (responsible for performance management) also attend the AC meetings. At MUN2 the chairperson of MPAC is invited to attend the AC meetings as well as the AGSA strategy and planning meeting and the full MPAC is invited when the financial statements are reviewed. The reason, as explained by the CAE, is to both empower and inform councillors.

The mayors or representatives of council also indicated that ACs add value to the mayor in strengthening the oversight role, assisting them in having a better understanding of the financial statements, and giving comfort to the mayor on other areas for which the AC is responsible. The mayor at MUN7 also indicated one of the reasons he attends the AC meetings is because of the debates and interrogating questions as this gives him a much better understanding of the issues. Through attending he also wants to show his support to the AC. The council representative at MUN6 mentioned the recipe for success at the municipality was that there were no clashing personalities and the AC was seen as a tool rather than a threat by management contributing to the relationship and communication between the AC and MAYCO where the AC has the courage to openly speak and objectively indicate areas that need attention.

At MUN6 the challenge of councillors merely noting items brought to their attention by the AC without specific action has been addressed by the ACC through interacting with the mayor prior to the council meeting and using the CAE during the council meeting to get the message across to councillors.

*[If the AC] feels that they're [audit committee] not really taken seriously in that council notes most of their stuff, ... or there's no specific decisions taken on some of the advice that they give, then [the ACC] would request a meeting with the mayor beforehand and then he would have the discussion with the mayor, with the internal auditor executive also present, and I know of one or two times while the item is tabled then [the CAE] would bring up specific points and what [the CAE] also does when he does his report in terms of performance management, he would then say that the committee specifically advises that this and this needs to be done. He summarises the report on issues that council needs to focus on instead of them going through the full report.*

Another aspect of building relationships between the AC and council or contributing towards the council understanding the ACs' roles and responsibilities better is when the ACC or AC members attend council meetings. This is not an occurrence at all the municipalities in this research. At MUN 2 the AC attends the council meeting on invitation only, which happened regularly at early stages of the relationship but not for the past two years according to the ACC. At MUN5 the ACC or an AC member if the ACC is unavailable will attend the council meeting where the financial statements are tabled and are allowed to be part of the discussions.

The performance evaluations of the MM and management is another forum that can contribute towards building on the relationship and understanding of the role and value added by the ACC. It is a legislative requirement (RSA, 2001(b) section 27 (4) (d)) for the ACC to be part of the panel where the performance of the MM and his management team are evaluated. Despite it being a legislative requirement, participants also indicated the value they get out of the ACC attending these evaluations and the contribution it makes to building relationships.

Another vital relationship that featured during the fieldwork is the relationship between management and the ACC and AC. The importance of such a relationship was also recognised by the PSACF that issued guidance documents on the relationship between the public sector audit committee and management and between the audit committee and council (IODSA, 2014d; 2014e).



Throughout the discussions with participants from all municipalities an occurring theme, similar to the relationship with council, was the need for an open and good working relationship between the AC, ACC and management. The MM at MUN5 recognised it was not always the case and explained that:

*...communication is open, it's two way, it's meaningful I would say and then I think because we have that trust factor, that also helps a lot, that you, because if one looks at a couple of years back the purpose of the audit committee wasn't really that clearly defined and specifically if you have the majority of members coming out of, ... the private sphere, then it's not always so easy to get that relationship going ..., because at that time some committee members saw themselves as policing the municipality, and that's not always the case. And you need to, like I said, you need to build that trust, you need to build that respect. And there's a good relationship between the committee and the senior management. We know what we need to do, they know what they need to do ... they try and work towards ensuring that we have a better outcome.*

The CAE and MM at MUN1 confirmed regular interaction between the MM and the ACC. The AC charter at MUN1 is also the only charter that included a specific paragraph on the accounting officer (MM) that indicates the AC shall assist the accounting officer with financial management and other reporting practices, internal controls and management of risks, compliance, corporate governance, and performance information.

The MM at MUN7 recognised that for the AC to support the MM there needs to be a good working relationship between them. As part of the support to the MM the AC needs to provide information to the MM to assist with decision-taking. The example that was used are the recommendations made and questions asked on the performance management system.

The relationships between the IAF and the AC and the positive impact thereof on corporate governance and AC effectiveness have been demonstrated in research. Research has proven independence of the IAF is enhanced when it reports directly to the AC. There are reciprocal benefits between the IAF and the AC where effectiveness of AC is improved through the support and information they receive from the IAF. On the other hand, ACs play an important role in strengthening the independence and stature of the IAF in an organisation.

This research in general found a strong working relationship and good communication between ACs and the IAF. As the MM at MUN1 observed that the AC is only as good as the internal audit that supports them together with the MM.

The CAEs at MUN2, MUN4, MUN5 and MUN6 said there was an open-door policy and they were able to communicate in any form at any time with the ACC and the other AC members. The CAE at MUN4 indicated the ACC was the first person he would go to if there was a problem.

The CAE at MUN7 applauded the support from both the AC and management and indicated the ACC played a role in elevating the IAF within the municipality.

In compliance with IIA best practice, the ACs defined in their charters (for all charters reviewed) the scope of its relationship with the IAF. These include providing for private meetings between the CAE and the AC as deemed necessary and ensuring direct access by the CAE to the AC, ACC, and MM.

Another area where the AC plays an important role and where the working relationship is important is between the AC and the external audit as well as between management and external audit.

The AC charters at MUN2 and MUN7 require of the AC to provide an open avenue of communication between various parties including council, management, internal audit, and external audit.

An analysis of the roles and responsibilities of the AC regarding external audit indicate comprehensive responsibilities including *inter alia*: 1) ensure no restrictions are placed on the external auditors; 2) review the audit scope and approach; 3) review audit results and management action plans; 4) consider significant disagreements between external auditors and management; 5) consider material unsolved accounting and auditing problems; 6) ensure direct access to AC; 7) review fees and other expenses to be paid to AGSA; 8) meet separately to discuss matters private if so required; 9) identify key matters in management letter and ensure addressed; 10) review interim reports; 11) review the extent to which previously reported AGSA findings have been addressed by council; 12) advise the accounting officer on actions taken relating to significant matters raised in external audit reports; 13) address outstanding matters raised by external auditors; and 14) review coordination of external audit effort with internal audit. At one of the municipalities, one of the responsibilities indicated in the AC charter was to review the performance of the external auditors, however, this has proven to be a challenge in practice.

Based on own experience and through fieldwork discussions, the interaction between the ACs and AGSA was mostly limited to two meetings: the first when the AGSA presents the audit

strategy to the AC and management and secondly once the draft audit report and audit opinion are presented to the AC. However, over the last two years the interactions seemed to have increased mainly as a result of differences between management and the AGSA on audit findings and interpretations and the ACC or AC becoming involved as a facilitator.

At MUN1 the MM indicated they could always rely on the AC in cases where there were disagreements with the AGSA, and there was merit in the argument of management, to assist or act as facilitator.

The MM at MUN4 explained a conflicting situation with the AGSA and the support provided by the ACC in the situation:

*Now, the reason I'm telling you that, I kept my chairman of the audit committee in the line. I gave him telephonic updates and ... we haven't had that meeting with [the AGSA] and today's Friday. So, I said I'll meet you [the AGSA] tomorrow ... at your offices and we did. We met at 1 pm to 4.30 on the Saturday, But guess what I got [the ACC] to come. He came and sat next to me. He didn't have to; it was a Saturday afternoon. I had my chairman of the audit committee and that's something ... a real value add, he gave us confidence, an additional perspective, ... But we had the extra of our audit committee chair. He was there for 3.5 – 4 hours to conclusion.*

The ACC at MUN6 also indicated as part of the process management will immediately inform the ACC if there are findings by the AGSA that could impact on the audit opinion and the AC would play a significant role as facilitator in disputes. The AC has an official meeting with the AGSA once a year.

During the fieldwork some of the ACCs also expressed concern and frustration that might be indicative of some challenges in the relationship with the AGSA.

*Issues that I've got with, specifically with local government, how the audit committees are able to exercise their oversight. There's only one area that I can think of and that is in relation to the Auditor-General. You know because the relationship of the audit committees to the external auditor is totally different from the private sector, where in the private sector there is a lot more oversight that they have over the external auditors and with local government, they get the money from their Act [AGSA]. That's always a bit of an issue. ... Sometimes you find that the Auditor-General think that they need to review the audit committee. That is something that is a bit irregular. ... That is something that should be looked, I'd like that to have changed, but I also understand why at this point in time it's not a good thing to change it. Because of*

*the fact you have different levels of capacity and, so if you've got a strong audit committee then it's fine. The audit committee can oversee all the assurance functions but if it's a very weak audit committee then you know they're not going to be able to do that.*

There appears to be some strain on the important relationship between the AC, management, and members of the AGSA. The purpose of this study was not to focus on the nature of the relationships but more the importance of the various relationships between the AC and other governance role-players. Especially in light of the new Public Audit Amendment Act (5 of 2018) (RSA, 2018) where the mandate of the AGSA has been expanded, the need for creating platforms where healthy and necessary relationships can be build needs to be further explored and should form part of future research.

Trust has been identified as an important contributor in building good relationships between the AC and other governance parties.

The ACC at MUN2 felt trust is created over time:

*[Trust is very important. I am not going to mention names. You have the one municipality where you have the trust where I have now been involved for 5 years and the other one where I have now been involved for about 6 months. It is all about who you are, can I trust you? I don't know you. But then they start realising especially if you start looking at their risks and internal control measures within the municipality and where you indicate to them the critical risks that have to be addressed urgently.*

The CAE at MUN6 had the following to say about trust:

*It's like internal audit. For you to be a trusted advisor, there needs to be trust in you as an auditor. The same with the audit committee, to listen to their recommendations and accept their recommendation and put value to it, you must have faith in your audit committee's ability, and I think that is where we are doing well. We'll probably get to the abilities and their qualities and their experience and so on and because of that and because of the quality of the recommendations that came from them, I think there is a lot of trust in the audit committee, so they do take their recommendations seriously.*

The MM at the same municipality agrees:

*... but then also there must be that trust between the committee and the council or administration as well to actually believe that if we do make a statement that they do believe the statement and you do not have this personal thing. My previous experience was sort of like a personal thing, you don't really believe what the municipal manager or administration is*

*saying and therefore you feel that you need a separate investigation. So I think the whole thing about trust, and I believe that is only built if it's mutual, but also if it is built on facts. So, when you do give information through, the information can be substantiated and it doesn't differ, you know from one report to another.*

### **Fieldwork praxis tips**

- Build trust relationships.
- Establish relationships through interactions.
- Involve AC with strategic planning sessions.
- Improve communication tools in dealing with council.
- Cover relationships as part of AC charter.
- Create platforms to build relationships between AGSA and AC.
- Get clarity on role of AC in evaluating AGSA performance.

### **Concluding observations – Relationships**

Good relationships between the AC, council, the mayor, management, IAF and external audit were identified as key to effective ACs and in providing the AC with the necessary authority. These relationships need to be open and honest and be built on trust and regular interactions between all these role-players. Through interactions, a better understanding of the role and value adding of the AC can be established contributing to improved governance. During these interactions, the style of communication is also important to bring messages across and get buy-in from the different role-players.

The views of participants in this study indicated good working relationships between the various parties with regular interactions including honest feed-back. Improvements in communication to council have been identified as an area that needs improvement. Another area in relationships that need further attention is between the various role-players and AGSA.

Although the research cannot attribute positive audit outcomes directly to good relationships between the various parties, good relationships result in trust being created, using the AC as a tool rather than a threat, and thereby contributing to improved decision-taking and an improved control environment that impacts positively on audit outcomes.

Closely related to the relationship between the AC and other parties are the support and resources provided to the AC. The participants refer to a variety of type of resources and support that are provided (or not) to the AC. Under the next heading the findings of this research on resources and support to the AC are further explored.

#### *7.4.1.5 Audit committee support and resources*

Based on the research of effective ACs and the views of participants in this research, resources and support to the AC include perceived supportive tone or attitude of top management, access to management, council and internal and external audit, timely, useful, reliable and quality information provided by management and audit, having sufficient number of AC members, training and professional development, and availability of time. All these resource and support areas, as perceived and experienced in the field, are further analysed in this section.

Provision was also made in some of the AC charters for the AC to supplement their resources by making use of outside advisors if so required. This section presents the views on this in practice.

The supportive tone and attitude towards ACs from both council and management was an important factor to investigate further during this research and has also partly been reflected under the heading 'Relationships' when the relationships between the AC and council and management was discussed. Some of the views expressed by participants showed a positive and supportive attitude towards the ACs by the mayor, council, management, and the CAE. However, contrary views were also expressed.

The mayor at MUN2 indicated that through regular interaction with the AC and discussions with management, he believes that enough support is provided and also stated:

*[...if they do get insufficient information they talk to the municipal manager and me, and we take steps to ensure they get the required information].*

The ACC at MUN2 during the discussion of support and resources mentioned other municipalities where the AC is seen as a threat by management and administration resulting in as little as possible time spent and support provided to the AC.

The CFO at MUN7 believes that not enough support is provided by council to the AC. He based this observation on the extent to which council reviews and interrogates the AC reports when compared to the review and interrogation of financial reports. Reasons for the apparent lack of review and interrogation could be as a result of the mayor being very involved with the AC and attending all the AC meetings giving the council a sense of comfort or it could be that the council does not really understand the issues.

The CFO stated that quality questions need to be asked and the style of asking the questions are also important. According to the CFO, the culture towards the AC could be a prohibition or support within a municipality depending on the attitude and stated support by the administration is very important.

The CAE at MUN6 confirmed the following in response to the question of whether the AC has power and authority:

*I think so. In our case specifically they've got the backing of council. They're appointed by council, after some serious thought and motivation. ... Looking here at a function outside of the municipality's operational influence, they look at who is the best, which I'm very glad for, and they've got the support, they've got the support of the municipal manger. They both understand their role and why the audit committee is there. So, and from a CFO definitely, the CFO sees them as a help. From CAE they're there to oversee my functions. So, I'm quite happy with that.*

The other areas that demonstrate resources and support are the accessibility of management, council, and internal audit. The lack of accessibility was not raised as a limiting factor at any of the cases. Accessibility is further discussed as part of the headings 'Formal meetings' and 'Informal interactions'.

Receiving timely, useful, reliable, and quality information from management and internal and external audit is an important enabling factor for effective ACs.

Based on the fieldwork and personal experience, the CAE plays a critical role in ensuring the AC gets quality information. This was also confirmed at MUN4 and MUN6. The lack of capacity at the IAF at one of the municipalities was given as a reason by the MM as why not enough



support (that they would like to give) could be provided to the AC. However, at the same municipality the CAE and the ACC were of the view that adequate support was provided to the AC. Challenges in receiving timely, useful, reliable, and quality information was not raised as a challenge at any of the municipalities. AC meeting information was received timely and covered the content required of the AC to review and advise.

All the AC charters analysed indicated a minimum membership of three and 66% of the charters reviewed also included a maximum limit of five members. The following table provides a summary of the number of AC members at the cases in this research obtained from the AC reports or annual report information:

**Table 7.4: Number of audit committee members at cases**

Municipality	Recommended number per AC charter	Number of members
MUN1	Minimum 3	2 – One member resigned during the year
MUN2	Between 3-5	3 members
MUN3	Not provided	Not available
MUN4	Between 3-5	4 members
MUN5	Between 3-5	5 members
MUN6	Between 3-5	3 members
MUN7	Minimum 3	3 members

Based on the information in Table 7.4 most of the municipalities currently appoint the minimum number of AC members as per charter requirements. This could again be ascribed to cost containment measures. At MUN5 the CAE equated having sufficient resources to the number of members on the AC being even more than the required 'at least three'. Despite the minimum number of members being appointed, at none of the municipalities were questions or challenges raised by participants on inadequate number of AC members.

In a constantly changing environment, continuous training and professional development is critical to maintain expertise and experience. The importance of having industry and organisational (for this research local government and the specific municipality) experience and knowledge was identified as an important determinant of effective ACs through research and during the fieldwork of this study. One way in which knowledge and expertise can be gained is through proper orientation and education (induction training) of AC members when they assume their responsibilities and for ongoing education through professional development.

Induction training did not necessarily feature high on the priority of resourcing AC members. Table 7.3 indicates that only 50% of the cases included a requirement of induction training as part of the AC charter. However, the importance of it is recognised especially in light of the challenge in recruiting competent members to serve on ACs. From the point of view of the CAE at MUN4:

*[That is why they need to be educated. You have to provide induction and send them for training if required. That is why it is important to have a sufficient budget for the AC. As I have indicated before it is very difficult to get members to serve on rural audit committees.]*

Various practices and praxis are followed for the professional development of AC members. In some cases, participants were uncertain on how the current practices work (MUN4) and some participants indicated not enough and adequate induction and continuous professional development occurs (MUN2 – MM; MUN5 - ACC).

*There are those that stay up to date but a large percentage of audit committee members, they pick up things as they go along, which is not ideal (MUN5- ACC).*

Although participants agreed that professional development was important, different views were expressed about who should take responsibility for this. Two schools of thought emerged during the fieldwork. On the one hand, the view was that it was the responsibility of the AC members themselves to ensure professional development, while the other school of thought was that it should be the responsibility of other institutions. The major factor to inform the views appears to be the cost aspect.

A view of one of the proponents for professional development being the responsibility of AC members themselves was at MUN4 where the mayor believes it is the responsibility of the municipality to ensure the right people are appointed on the AC but then it is the responsibility of the AC members themselves to ensure professional development.

The mayor at MUN5 was of the opinion that the municipality should not get involved and direct the AC members to go for specific training as this might impact on independence or perceived independence. The mayor was, however, quick to mention the AC members stay current, which is demonstrated by their knowledge of GRAP and MSCOA.

On professional development being the responsibility of other organisations, various participants referred to the Audit Committee Forum, an initiative put in place by Provincial Treasury to capacitate AC members. Unfortunately, this initiative was discontinued for

different reasons, including poor attendance. Poor attendance was mostly because of the cost and municipalities not being prepared to carry the travelling and other costs for AC members to attend. Another reason was that only ACCs were invited, so if they could not attend, no replacement for other members were provided for.

The CAE at MUN4 suggested joint responsibility for professional development where the AC member is responsible to stay abreast but the municipality should also provide resources for the AC members to attend training provided through other platforms, for example, the PSACF and others to make sure the members stay up to date with new trends and developments. He also indicated professional development happens in many cases over time as they learn more about the activities of the AC including risk management and performance management. The MM at MUN6 also indicated some initiatives were taken for the training of ACs but emphasised it is important to appoint competent members as a first prize to minimise training costs.

*We've requested the Department of Local Government for training, specifically for audit committee members and I think that is also very important. ... they need to stay up to date with developments, ... with any new legislation or interpretation of legislation, or any judgements ... from the court side. That's happening more and more, but I think the training part, I think that needs to happen. ... I think for the most part we must make sure that we get the right people that you do not have to necessarily train them from scratch specifically so that they can be able to understand their role. That for me is more important than afterwards. ..., if you have good members, sometimes you don't even need to train them, appointing the right person on a committee that is able to self-learn and you know, want to be on top of things all the time, that's probably the better way of doing it. Training is not that expensive, but if in our case, if they do not present the training here, people need to go to ... then it's the travelling and accommodation that actually add mostly to the cost than the actual training itself.*

The CAE at MUN6 also referred to the now-discontinued AC forum but stated it later became a complaints forum mostly about remuneration. He has, however, recognised there is a need for a forum where knowledge is shared.

*But the orientation and regular keeping up to date is a problem. We used to have the ... audit committee chairperson's forum which I think has died a slow death. I think that must come up again. I attended some of those meetings and unfortunately at the meeting what is discussed the most is the remuneration. I'm not getting paid enough. This guy pays me like this, the other municipality pays like that. That's not the issue. The issue is there to share ideas, concerns,*

*areas that we need to look at. So that forum needs to be maybe get going again but not as a complaints forum, as a sharing of knowledge and ideas like the CAE forum where people come up with the ideas and they give presentations and the audit CAE picks up what might be applicable to others. Let's share some ideas. I don't think that's working and orientation, when it comes to the practical side, the book says one thing, and this doesn't quite fit in anywhere. How do we deal with that? That's where the forum is important.*

At MUN7 the MM was of the view that the CAE needs to play a role to ensure AC members stay informed about changes in the local government environment.

The one ACC involved with various AC meetings strongly expressed his views on professional development and the way it is co-ordinated and executed:

*I think that there's a lot of evolution that happens within local government, you know. And yes, I might – have some specialist knowledge in my areas of expertise and I might have experience in local government but the one area where support can be given is with training. When there are newly developments, the things that audit committees get capacitated with. If your audit committee members have got a good understanding as to changes and things, then they can better advise the entity. Sometimes you find that the audit committee members are not even aware of changes that happened, and they now must give an opinion about it. So, if you've got proactive assistance in terms of that. I think that is probably an area where it's lacking. The other thing related to that, is that it is – look – yes council budgets for expenses in audit committee but as I said as a unit there's no budget for an audit committee to say that we're budgeting x amount and the committee can then apply that money so if they wanted to have specialised training, anything that the audit committee needs comes more on an ad hoc basis. If we look at it, the importance of the audit committee and the responsibility that they've got, the percentage of money they spend on the audit committee in relation to the budget is totally skew. So, I think that they could spend a little more on capacitating the audit committee in general.*

On the process of professional development and the role of different parties, three of the ACCs that are involved with a few ACs believe that the current process of arranging for some training to ACs in local government is flawed. Professional development initiatives are limited and un-coordinated. A further explanation provided by one of the ACC was that Provincial Treasury communicates the training to the municipalities, so if the municipalities do not inform the AC members or do not want to carry the cost of the training, the AC members cannot attend. The training invitation is also restricted to the ACC only. That means if the ACC cannot or does not

want to attend, other members are automatically excluded because they do not get the invitation. He suggested the following:

*Now I'm saying that you know what, all the municipalities should be prepared to invest something towards capacitating audit committee members. I'm not saying you should train people in every spectrum, but you should invest at least something. ...*

*So, the focus on the chairperson only so maybe they can expand it. Because the person that is sitting next to me can be the next chairperson. ... That body should be more principled and communicate directly with audit committee members or people who are on the committees.*

*... also get input from audit committee members as to what the agenda for these seminars and things should be. You tend to find that they put something together that they think should be covered. Maybe I can tell them that you know what, this is a risky area that is coming up, and the committees should address this thing. Consultation doesn't happen a lot. .... Maybe [the responsibility] can be within Treasury but ... they should have a management committee made up of representatives from audit committees that can actually drive the agenda there.*

Various other recommendations were made during the fieldwork on how professional development can be encouraged, monitored, and improved.

The MM at MUN4 suggested that various organisations with an interest in local government for example SALGA could become involved with professional development of ACs.

The CAE at MUN7 recommended that to ensure members stay current, a practice whereby AC members declare their Continuous Professional Development (CPD) hours annually is implemented.

Time is an important resource for the AC members' ability to function effectively. Time for this research includes AC members having enough time to thoroughly prepare for meetings, enough time to conduct effective meetings and have time available for interactions over and above formal meetings if so require.

Various parties stated the AC members have enough time for preparation as they get paid for their preparation time (MUN6 – MM; MUN5-CAE). Another resource mentioned by participants is that the AC receive the agenda pack well in advance, mostly a week before the meeting, to enable the AC to prepare and interact with one another before the meeting (MUN1 – CAE; MUN2 – MM; MUN4 – CFO, CAE; MUN5 – CAE; MUN6 – MM and CFO).

At some of the municipalities, the praxis of regular interactions between the AC members and the ACC prior to the meetings by way of telephone calls, e-mails and WhatsApp groups where detailed discussions of salient issues are held are taking place. The benefits of these timely

interactions are to ensure the whole AC is informed of the matters and the AC, having agreed on issues before the time, communicate as a collective ensuring clear and consistent communication.

The general view on meeting time was also that restrictions are not put onto the duration of the meetings and the meetings last as long as it is required, or if not enough time is available, an additional meeting will be scheduled (MUN2-MM; MUN5 – Mayor, CAE).

*We book the whole day for those meetings, there's no time connected to the duration of the meeting. But I must say each and every item we will go through thoroughly and have discussion and even if there is more information that they might pick up, they might ask for more information as well. So, I will say yes, it does allow quite some time to engage and to get to standard in terms of what is happening in the municipality and what are the key areas. (MUN6- CFO also confirmed by CAE).*

At MUN6, the ACC also confirmed that the ACC makes sure enough time is spent during the meeting.

On the other hand, some of the participants believed that AC members, having other professional responsibilities, might not necessarily devote enough time on some of the required areas.

*As far as I am concerned, sometimes I get the sense from ..., that some of them are pre-occupied by their own things. I mean he is a businessperson. Another member of the audit committee also have an own private finance business. So, you would sometimes find that it is difficult for them to be able to address issues of the municipality, but certainly pre-planned meetings they are there. You can see they prioritise this meeting. ... But in terms of extra,*

Based on the experience of the researcher serving on ACs, the option to use outside advisors is not utilised by ACs. One of the contributing factors could be the associated cost that municipalities will have to carry, and the limited funds municipalities have available. Another reason could be that the ACs have not considered it to be necessary. One of the ACC in this study also mentioned the limitation of having to go through the municipalities' procurement and approval process if the AC wants to make use of outside expertise. He explained it as follows:

*Although you find that your charters generally allow that should the audit committee need specialists to assist them, you know that they can procure it, the services, within the supply chain management regulations of the entity. I think that maybe that is something that is not, practice. There is always a bit of reluctance, especially I can recall a case where the audit*

*committee actually needed legal advice, but it's legal advice actually against the entity, management, the municipal manager and council and then there was a bit of reluctance to assist the audit committee. They never got the opportunity to the legal advice.*

The reasons for the apparent lack of using outside advisors did not form part of the scope of this study and could be an area of future research.

### **Fieldwork praxis tips**

- Include induction and professional development as part of AC charter.
  - AC members to declare CPD hours to indicate continuous professional development.
  - Establish a coordinated effort by different organisations for professional development of AC members.
- Informal communication and interaction among AC members prior to meeting.

The next subsection presents the analysis and findings of this research on the AC composition and the appointment process.



### Concluding observations – AC support and resources

Resources and support comprise of various elements. Similar to the observation under relationships, the culture of the organisation, including the supportive tone and attitude of management, council, and internal audit is an important resource to the AC, without which they would be unable to fulfil their responsibilities. The ACs further have unrestricted access to representatives of council and management through formal and informal interactions. Receiving timely, useful, and reliable quality information was also identified as an important resource for the AC, and in this regard the CAE performs an important function. AC members receive the meeting information in advance to enable them to properly prepare for the meetings and the content is sufficient to fulfil their responsibilities. In some cases, informal interaction among AC members take place prior to the meeting that enables them to be well-prepared and communicate as a collective. The time spent during the meetings was also considered to be sufficient. Although in most of the cases only the minimum required number of members were appointed, this was not raised as a challenge. However, one challenge raised relates to the induction and professional development of AC members where, although the need for and importance were confirmed, there are different views of who should take responsibility and bear the cost. This area was also not adequately covered in AC charters. The current efforts for professional development seem to be limited and uncoordinated. Recommendations were made on how professional development can be encouraged, monitored, and improved by involving more parties with an interest in local government governance. Time was another important resource and includes preparation time, meeting time, and interaction time. ACs received information timeously and no criticism against meeting time was expressed. However, a challenge was additional effort by AC members, expected from stakeholders, as a result of serving on ACs not being considered a full-time first-priority professional responsibility. Currently, the use of outside advisors as an additional resource to the AC is limited. The link between AC support and resources and favourable or less favourable audit outcomes that was observed during the research includes support during interactions with the AGSA and time availability for AC inputs to draft financial statements before submission to the AGSA. Support of the ACC during interactions with the AGSA has, in some cases, contributed to positive audit outcomes. The tight timeframes for ACs to provide inputs to draft annual financial statements have in some cases contributed towards negative AGSA findings. It could also further be argued if there is improved focussed training and development of AC members the quality of recommendations by the AC can be improved.

## 7.4.2 Audit committee composition and appointment

One of the purposes of this study was to determine the professed effectiveness of ACs in the cases by comparing the composition of the AC members and ACC with the requirements contained in the legislative framework and best practice principles, as well as against the expectations of the stakeholders. The composition of the AC for this research includes the sub-themes of experience and expertise, characteristics of AC members and the ACC, independence, and diligence. Closely related to independence and experience is the appointment process, which is also reflected on as part of the results of research. Throughout the research, all municipalities shared the challenge of attracting the required skills and experience of members to serve on the ACs. This challenge together with different delegations at different municipalities have resulted in different appointment processes followed. Information on the practices and praxis in the AC appointment process are presented under the heading of 'Appointment process'.

### 7.4.2.1 Appointment process

Under the heading 'Appointment process' the analysis will include the challenges in appointing AC members and ACC and the different practices and praxis followed during the appointment and approval processes.

One of the most significant and pervasive challenges identified throughout the research by participants is the difficulty to attract the required skills and experience of members to serve on local government ACs. The problem of recruiting the necessary and skills and experience on ACs were strongly expressed by all the municipalities in the sample. Two participants also observed the challenge of and the need to attract younger people to serve on ACs. The lack of the ability to attract the required skills to serve on the AC even resulted in a control weakness finding by the AGSA at one of the municipalities. The difficulty in obtaining audit committee members with the required skills and experience, at especially small municipalities in Wales, has also been identified by Davies (2009:46).

The following are examples of statements made in this regard by participants:

*[For us in the Northern Cape it is very difficult to get competent people. And you can't just appoint anyone. We struggled to get people. ...and the process to appoint a chairperson ... we advertised and two people applied. Only the one person arrived. But he had the*

*qualifications and expertise of a chairperson required. For the other two members we advertised. We did not find any people and then we decided to head-hunt.]. (MUN1)*

Participants in the Western Cape expressed similar concerns:

*...when you're out of the big cities it's not easy to get qualified people, sustainable, sometimes you get a person who says okay I'll do it, then they stay for two meetings, but the travelling is too much. (MUN5)*

*So, you don't always get the correct people or people are not interested. They've had enough; they're retired. (MUN6)*

*[But it is really a problem in the rural area to get competent people ... in this year I will again have a problem in that two members need to be replaced. We just don't get the competency. Then people have to come from Cape Town and then it is additional costs for the municipality for every meeting.] (MUN4)*

Various reasons for the inability to attract the required pool of suitable AC members were identified.

The first is the remuneration paid to AC members. Remuneration paid to ACs in local government and recommended by National Treasury was considered to be very low by some of the participants during the fieldwork especially in relation to the amount of time required to adequately fulfil their responsibilities. Remuneration could also impact on the diligence of AC members, which is further discussed under the heading 'Diligence'. The CAE at MUN1 indicated that people require remuneration over and above what the municipality in the rural area can afford. If members outside the region are appointed, the cost escalates due to high travelling costs.

Another reason is that qualified professional people do not want to be associated with municipalities that perform poorly or have poor governance and the possible reputational damage if they are associated with a municipality that performs poorly. (MUN1; MUN6).

The CAE at MUN6, while discussing diligence and commitment, shared the view expressed by one of the AC members:

*I said why did you choose ..., he says it's because it's one of the better run municipalities. He's had enough of these others.*

At MUN1 the participant observed:

*[I have noted you get two types of potential audit committee members. The one group that decides I will never be associated with this municipality based on what I read or what I know*

*and experience being a citizen in this town. This person might be a specialist and can add so much value but because of the stigma they are not prepared to be part of the stigma. Then you get the other group that will say despite the stigma I want to get involved and see what I can do and what my contribution can be to assist in turning the situation around and correct it.]*

Another possible reason indicated in the research, but which did not feature during interviews with participants, includes potential legal liability.

The research indicated that two main processes are followed to identify potential AC members: through a normal advertising process (66% of the municipalities) or by way of head-hunting (33% of the municipalities). Head-hunting was specifically used in the Northern Cape, mostly because of the challenges in obtaining the necessary skills and capacity to serve on ACs.

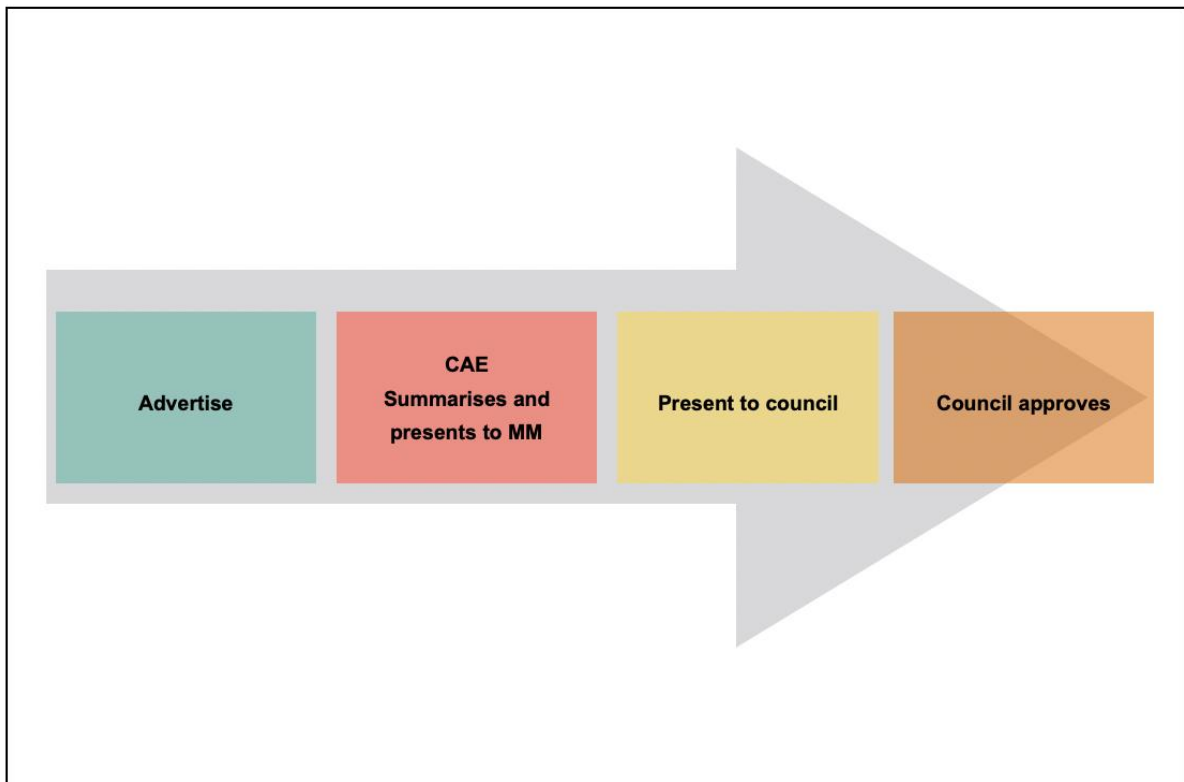
The lack of available and interested AC members with the necessary experience and expertise necessitates the need to head-hunt and in the process sometimes relies on contacts or previous acquaintances that management or AC members know and have. The appointment of these contacts or acquaintances may call the independence of the members into question. However, although various examples of appointments based on previous contacts or connections were identified during the fieldwork, it was never considered to impact independence but rather contributed to a much more open line of communication and being 'free and frank'. Independence of AC members is further explored and presented under the heading 'Independence'.

At MUN1 the MM explained the appointment process to advertise first, and if the municipality does not get applications from people with the required skills and expertise, they approach their AC members to suggest possible individuals that can be approached by the municipality. The charter at MUN1 merely states the appointment of the AC must be approved by council and the chairperson shall be appointed by council.

The most general approach followed by the different municipalities for the appointment of AC members is depicted in Figure 7.1.

Advertisements are mostly regional and not national. The main reasons are to appoint local people, thereby reducing travelling cost to be paid to AC members. Further, the perception is that local people have a vested interest in having a municipality with good governance as demonstrated by the following quote and confirmed at MUN4, MUN5, and MUN6.

*The audit committee would like to appoint people from the community, from local. Because that person has got a vested interest in the municipality. I want to see the municipality run well because I am a taxpayer, that kind of thing. (MUN6-CAE)*



**Figure 7.1. General appointment process for AC members followed at municipalities**

Variations on the general process depicted above were noted in that some municipalities conducted interviews while others did not and there were variations on the involvement of the MM and who made the final decision.

At MUN4 a panel is made up consisting of the mayor of the leading party, a member of the opposition party, the MM, CFO and CAE. The MM, CFO and CAE are only observers. The decisions on appointments are taken by the mayor and the panel of councillors after the applicants are interviewed by the panel. The decision is taken to MAYCO. MAYCO makes a recommendation to the council and council makes the appointment. At the same municipality, the mayor also highlighted the importance of a complete packet of competence in the AC and the need to recruit and appoint people that will ensure this package of competence. The CAE agreed with the practice to involve members of the opposition party as part of the panel for

reasons of transparency. The charter of MUN4 also merely states the council must appoint the AC members and an independent non-executive chairperson.

At MUN7 minimum requirements are identified and advertised, the CAE summarises applications and qualifications, the mayor and MM scrutinise the list and from the existing collective AC experience and expertise identify the gaps and what applicant best fills the gap, and make a recommendation to MAYCO. Thereafter, it is presented to council and council approves. According to the mayor, the approval by council is merely a rubberstamp due to the involvement of the mayor in the review of applications and recommendations. The charter indicates the members are appointed by MAYCO.

At MUN5 the approval for the appointment of the AC has been delegated to the mayor. In that case, the CAE compiles a matrix of all applications with an indication of the expertise and experience. The mayor in consultation with his caucus reaches a decision and appoints the AC members. The MM is not involved at all and said he prefers that, seeing that the AC is a sub-committee of the council:

*[I do not say people are like that but if it is your work that is assessed would you not rather look at appointing weak lambs rather than bulldogs, so I am comfortable with it to say it is fine. These are the appointments that you {the mayor and caucus} want].*

Interestingly, at MUN6, the praxis differ from the other municipalities in that the AC members themselves conduct interviews with the short-listed applicants and the AC members recommend who they would want on the committee. This requirement was added to the AC charter that included the following section: 'All applications will be reviewed for completeness and summarised by the CAE. The summary will be forwarded to all Committee members for their review and recommendations on applicants that should be short-listed. The AC will then provide a suitable interview date.

- The interview panel will consist of all the members of the Committee as well as the CAE.
- Once the Committee has made the selection of the preferred candidate, The CAE will prepare a Municipal Council meeting agenda point. The CAE will represent the Committee during the Municipal Council meeting.
- Once council approval has been obtained, the CAE will inform the successful candidate in writing under the signature of the Municipal Manager.'

The ACC indicated that he proposed this arrangement specifically to ensure the skills and competence of members appointed to the AC is adequate. The MM agrees with the motivation: *I'm quite happy with that process because it's an open process. I think that everything, because we do not want to have a situation where people say you are appointing members that you know is not going to interrogate like you guys do. ... Because we want them to take ownership of the committee themselves and not feel as if they're being pushed for members that they're not feeling comfortable with, or that they know it's just going to be a warm body that's going to come and sit there. We don't want that.*

The council representative concurs with the appointment process because it is well-motivated and allows the councillors to ask questions on recommendations, but they never really veto the recommendation.

Different practices are also followed by different municipalities on the appointment of the ACC. At MUN4 the councillor panel consisting of the mayor and a member of the opposition party decide on who should be the ACC. At MUN7 the MM in consultation with the mayor decides on who to appoint as ACC.

One of the recommendations on the appointment process made by the MM at MUN7 was to appoint an interview panel (comprising of an external party, internal audit, and MM) to interview applicants to make sure the appointed individual will fit into the culture as well as requirements of the municipality. The practice of interview panels has been implemented at some of the municipalities as indicated in this section.

Another interesting recommendation made by one of the MMs is to have the entire funding and appointing process transferred to Provincial Treasury. He argued that if the appointment process is managed by Treasury it would address the risks of AC members not being independent or the manipulation of the appointment process. If funding is governed by Treasury, it will address the challenges of unaffordability and lack of access to competent AC members especially at rural municipalities. Through their management process, Treasury could also ensure the pool of available AC members comply with professional development requirements, for example, continuing professional development. This recommendation is further discussed in subsection 7.4.8.



## **Fieldwork praxis tips**

### **Appointment of AC members**

- Conduct interviews with potential members.
- Involve current AC with selection of new members.
- Transfer appointment and funding of ACs to Provincial Treasury.

### **Concluding observations – Appointment process**

One of the most significant and pervasive challenges identified throughout the research by all municipalities is the difficulty to attract the required skills and experience of members to serve on the AC, especially at rural municipalities. Some reasons include the low remuneration paid and the possible reputational damage of getting involved at municipalities with poor governance. To address the challenge, some municipalities revert to head-hunting including calling upon previous contacts and acquaintances. This could result in the independence of the AC being questioned. However, some mitigating actions may address the risk of possible bias, which are discussed further under the heading 'Independence'.

Various practices and praxis are followed in the appointment and approval processes of AC members and ACCs. In some cases, the mayor is responsible, while in others, the mayor and MAYCO is involved, or the mayor and the MM. At one of the cases the AC is responsible for interviewing, deciding, and recommending new appointments.

The challenge of recruiting suitable skilled and competent AC members have resulted in negative audit findings at one of the municipalities. What also became apparent during the study was that well qualified and competent potential AC members do not want to be associated with poorly governed municipalities. This lack of association could result in municipalities that need competent and experienced AC members not being able to recruit such members and as a result not receiving quality recommendations contributing towards positive audit outcomes.

The skills and experience necessary to serve on ACs are included under the heading of 'Experience and expertise of audit committee members'.

#### *7.4.2.2 Experience and expertise of audit committee members*

The need for AC members to have the necessary experience and expertise is a critical determinant of effectiveness and a consistent theme in the literature on AC effectiveness. Throughout this research, participants also indicated the mix of skills and expertise of the AC to be an important determinant of effectiveness.

Despite mixed results in this research of what those required skills and experience need to be, there were consistent views on some of the required skills and expertise, including the areas of finance, auditing, and local government experience.

The mayor at MUN5 expressed his expectations on the competency of AC members:

*For me, the members of the audit committee must have sound accounting knowledge, number one, which is why I appointed the CA ... there must also be some type of evidence of auditing experience. It doesn't have to be municipal auditing but auditing experience.*

The MM at MUN6 stated:

*In our case specifically, we looked at members that can actually contribute meaningfully to the advisory role. We didn't just appoint members ..., but what we basically looked at specifically was the competency and experience and not just in local government, but specifically in terms of HR, finance, and supply chain also on the one hand. And for us, it was important to get the right people for the job if you can call it that. Because we wanted to make sure that it's a committee that can contribute meaningfully as opposed to being a committee for compliance sake.*

Another respondent linked expertise and knowledge to authority:

*You know for you to make recommendations you've got to talk out of a level of authority. That comes from knowledge and expertise.*

This view was confirmed by the representative of the council at MUN6:

*[If they did not have the expertise and were weaker technically as our own CFO, who would listen to them? You know then it would just be do what you have to do, get it over and done with. But the fact that they are experts makes it different].*

The AC charters analysed, all included a section on composition or structure of the AC including what skills and experience are required. One example from an AC charter:

‘Collectively possess the following skills and experience: private and public sector experience, understand service delivery priorities, good governance and or financial management experience, understand the role of council and councillors, understand the operations of the municipality, familiar with risk management practices, understanding of internal controls, understanding of major accounting practices and public sector reporting requirements, understanding of public sector reforms, familiar with local government legislation, understanding roles and responsibilities of internal and external auditors, understanding treatment of allegations and investigations and understanding the performance management system’.

Another municipality included a much shorter and concise description in its AC charter:

‘...Audit specialists/professionals. The members of the Committee should, as a whole, have the necessary financial literacy, skills and experience to execute their duties effectively.’

The CAE at MUN4 explained that due to the shortage or lack of access to local members with experience and expertise at rural municipalities, it is sometimes necessary to appoint people without local government experience. In those instances, he said induction, training, and the required budget should be set aside to capacitate the AC members.

Although the King IV requires that the qualifications of AC members should be reflected in the AC report, a review of the different AC reports revealed that none, except one, included the qualifications of the AC members. However, during the discussions with the participants, the topic of experience and expertise AC members possess were addressed, and the following table was compiled based on responses.

**Table 7.5: Summary of areas of AC expertise at cases**

Expertise	MUN1	MUN2	MUN3	MUN4	MUN5	MUN6	MUN7
Forensic	√	√					
Financial	√√√	√√√	√	√√	√√√	√√	√
Legal					√		
Performance management				√	√	√	√
Local government		√		√		√	√
Internal audit	√	√	√			√	
Risk management		√			√	√	
External audit	√		√	√		√	
Serving on other ACs	√	√		√	√	√	√
Other		√		√√		√	

Based on the information in Table 7.5, it is clear the most common area of expertise in the sample of municipalities is in the field of finance. One criticism against compositions of ACs expressed by some of the participants is that it may consist of too many financial experts or chartered accountants (MUN1; MUN6; MUN7). From Table 7.5, it can also be deduced that many of the members also serve on other ACs. The spread of expertise seems to comply mostly with those identified by research and best practice to include financial expertise, assurance (internal audit and external audit), risk management, and knowledge of the sector. Performance management, although not one of the areas specifically identified as part of other research on effective ACs, is applicable in the South African context as a result of the specific legislative requirements for ACs (section 4.13).

At the one municipality, one respondent opined that legal expertise on the AC does not add value through contributions at the meeting, which is understandable because the scope of the work of the AC focuses on other areas. However, at another municipality, a participant indicated legal expertise to be an area where the municipality would prefer to get skills on the AC.

Other skills and experience included in other charters not covered above are understanding of sustainability reporting, integrated reporting, and IT governance. Other considerations for appointments over and above experience and expertise identified include equity, personalities, communication skills, fit into the culture of the municipality, and being up-to-date with new developments.

At all the municipalities' participants indicated their satisfaction with the current mix of skills, experience, and expertise. The only area identified where specific expertise was required was in the field of ICT (MUN4; MUN5; MUN6; MUN7). One participant believed the AC could have added more value with the whole MSCOA implementation process if they had more ICT skills on the committee. Two participants also indicated performance management to be an area where AC members sometimes lack expertise. The lack of AC members' skills and experience in ICT and performance management was also identified by the AGSA (2015:13).

As a result of the importance of experience and expertise as perceived by participants as a prime feature of effective AC members, the competencies and expertise of the AC need to be made visible through disclosure in the AC report. However, a review of the sample AC reports indicated only one municipality included the qualifications of AC members in the AC report.

### **Fieldwork praxis tips**

- Disclose AC members expertise/ qualifications in AC report.
- Guard against too many financial experts.
- Include ICT and performance management expertise on AC.

### **Concluding observations – Experience and expertise**

ACs should comprise of a mix of the necessary experience and expertise to be effective. This research indicated mixed results of perceptions on those required skills and experience but agreed that expertise in finance, auditing, risk management, performance management and local government were essential. The most common field of expertise required is in the area of finance.

A comparison of the current experience and expertise at the cases against that proposed in research and best practice show AC members generally had a mix of skills and experience to manage AC responsibilities and activities except in the areas of IT and performance management.

A review of the AC reports also indicated that, despite the view that expertise and experience are considered to be necessary, the qualifications of members were not disclosed in the AC reports.

The research further demonstrated a link between lack of AC experience and expertise in Performance Management and negative AGSA findings on performance management.

Our analysis suggests that participants' sense of AC effectiveness is related to the background that members possess in terms of expertise, expertise, and skills. Under the next heading of 'Characteristics of members and chairperson' the analyses of other characteristics respondents perceive to be determinants of effective ACs and ACCs is presented.

### 7.4.2.3 Characteristics of members and chairperson

The characteristics of AC members and particularly the ACC appears to be a key element in the impact of the AC on the organisation. Critical to the construction of effective ACs and ACCs, this study revealed that skills in questioning and asking challenging and difficult questions are considered to be an essential characteristic. Other characteristics that construct effectiveness per the research include the status and credibility of the members, objectivity and integrity, leadership, leadership behaviour of the chairperson, and effective interpersonal and communication skills.

The interviews and analysis of characteristics that are considered to be important for effective ACs based on the fieldwork determined a total of 17 characteristics. Some of these have been grouped for this research and the six most important characteristics identified throughout all the cases include displaying strong personality and actions and integrity and honesty. In the second place, independence and objectivity were considered to be key (presented under the heading 'Independence'). Together in third place were leadership, not being easily influenced, and understanding the local government environment. The important characteristics identified through the interviews show similarities to those identified in previous research. The strong personality and actions identified during this research can be equated to, among other things, the skills and ability to ask challenging and difficult questions, interpersonal and communication skills, and not being easily influenced. Objectivity and independence, integrity, honesty, and leadership including that of the ACC are consistent characteristics between this research and previous research results. These main categories of characteristics will be further elaborated on in the paragraphs to follow.

Other characteristics not forming part of the top seven but alluded to by participants included status, instilling trust (also covered under the heading 'Relationships') and respect, having an enquiring mind and encouraging motivation, keeping information confidential, focussing on substance, and commitment (discussed under the heading 'Diligence').

The first of the top seven characteristics identified by participants namely 'displaying strong personality and actions' was a common finding in all the cases. Statements made by participants and motivations in this regard include:

The MM at MUN5 felt that the need for a strong and robust AC depends on the level of governance and problems experienced at municipalities.

*[It depends from place to place. Maybe where it is not going so well, you will need a very strong and overwhelming robust audit committee. Here they are not overwhelmingly robust,*

*but they are also not a walkover. They will sit in at the meeting, give their opinion, ask questions that we will answer. ... They shouldn't be a walkover]*

The CFO at MUN6 agreed with the importance of AC members needing to be strong, knowledgeable, and have the correct behavioural skills to benefit a municipality.

*I think we have another person as well, you know, appointed, but he's purely from a financial point of view, but I think his personality in the way you engage, definitely how you manage it, definitely plays a role, so you need to have a person who's strong and knowledgeable, knows his or her subject and if it's not for that, you know surely then you will struggle to add value to the municipality, and I think in our instance we're quite fortunate to have those expertise available.*

The CAE at MUN2 referred to the support together with assertiveness by AC members:

*[They are very supportive, but they are also very strict. They don't want to hear about a limitation of scope. If we get a limitation of scope that we got now at ... the head of that section had to come and do a presentation on how he manages risks because internal audit was unable to test the controls. He had to do a presentation on how he manages risks, how effective are the controls ... because we were unable to audit it. ... Integrity and having backbone. Always be objective and not easily influenced because remember we are in a political environment].*

The mayor at MUN7 said the AC needed to demonstrate boldness and have courage.

Part of being considered to be strong-minded would include interrogation by way of challenging, context-based questions and dealing with controversial issues constructively. The CAE at MUN4 explained the process as follows:

*[Our Chair has a book that he brings into the meeting and he makes notes, and if something is not completed you will hear about it at the next meeting. He wants to know what the progress is and what have been done. He interrogates us. He does not want items to stand over. This is actually the first AC we have that functions like this. That is so effective. The previous audit committee just agreed with everything].*

The MM at MUN4 identified the following characteristics related to interrogation:

*An enquiring mind, a focus on whatever the substance ... under discussion or under review, I'm seeing that there's integration into that and risk-based discussion. So, I think they are continually, for instance, discussing something and I call it the potential problem analysis. That's my words I use, what if. So, they won't just say tell us about that construction you're doing, or that plant you're building and then they will say what if in terms of service delivery*



*and they will look for a deeper answer from a risk side. It's an oversight role that is alerting us sometimes to even basics that we overlook from that perspective. So, I would say the enquiring mind, and also they encourage innovation rather than just bureaucracy and following compliance.*

The mayor at MUN5 expressed his satisfaction:

*There is no time limit to the length of the meeting, and I am happy with the frequency and the discussions. There's lively debate in our audit committee meetings.*

The importance of interrogating discussion and lively participation by all the AC members was also alluded to by the ACC at the same municipality:

*It is very important. ... I would say that people report certain things to you ... But what you should always say is – so what has not been reported, and ask questions around those things, the things that are missing. I think a lot of the time people concentrate so much on what is in front of them they miss the fact that certain things have not been put in front of them. So yes, you must have those discussion because then out of those discussions you pick up a lot of other things, you learn about the entity and you may identify the risks. So yes – that's very important to have those discussion and in that, my expectation from audit committee members is that as I said, at a meeting each one should at least ask one good question that stimulates debate.*

The CAE confirmed this at MUN5 on internal audit reports issued:

*I can tell you this much, with this diverse group there's not one meeting that exists, okay that's fine, this report. They will go individually into that even in caucus and during the actual audit committee meetings itself. ... they will also have questions regarding a specific thing, and if they are not happy with the management comments, they would ask me did you consider this. There are interactions and interrogations of reports.*

At MUN6, the MM and ACC also expressed the need for interrogating questions.

*I welcome those type of interrogative questions and the debates that happen, it also gives me a chance or anyone else for that matter from the administration to also put their side of the story, or our side of the story, being available for them, if they have any probing questions that they would like to take further, those type of things. So that at the end of the day you don't have to – when they do actually give advice, that the advice is credible and can be used by us. (MUN6 – MM)*

At the same municipality, the CFO also attested to the importance of the interrogating questions:

*I must say I think from our side, you know, based on their expertise, they normally when they interrogate some of those reports, you know it's quite a lot of detail and from us as management sometimes you definitely have to be on your toes and to provide the answers and information and if not they will request you to go back and ensure that you do get that information and submit it at the next meeting.*

The CFO also stated that there are detailed discussions during the meetings:

*It's not a case of just a coffee drinking exercise.*

Interrogating questions made members more credible in the eyes of participants as it was perceived that members had the appropriate technical qualifications and ability to identify matters requiring additional attention.

As part of interrogation and debate, how it is communicated is also considered important. In that regard, the CFO at MUN6 observed the following:

*That was always one of the questions I asked, yes we must have an audit committee in place, you must have an internal audit unit and what is the real value they add, you know to the municipality and I had experience when we started where it was null and void, and that didn't add any value to the municipality or going forward. But I think what I experienced here definitely through those engagements, that is the way, the quality of those engagements and the way, communicated to us the administration, and definitely, for me, that is where you actually have to measure them in terms of the way, how they portray themselves, what value they add to the municipality.*

At MUN7, the MM also concurred with the asking of interrogating questions being essential and for this purpose the various managers need to be called in and answer to questions raised by the AC.

Also sharing the first place with 'displaying a strong personality and actions' in the top seven characteristics identified by participants was 'integrity and honesty'. Researchers and participants recognise that positive governance outcomes are attained when AC members have status and are perceived to be credible and demonstrate integrity and honesty in fulfilling their extensive responsibilities. The MM at MUN6 agrees:

*So it's basically, making sure that the persons that we have chosen or that we have appointed are persons of stature that can, within the community, if they bring out the report, the report would be meaningful, and the community would trust the report if I can put it that way or the outcomes of the report. In that sense, I think they do play a role and because of that, my view*

*has always been that we should support the committee adequately. Because it can make our work also easier.*

At MUN4, the mayor re-emphasised the most important purpose of the AC is to provide an honest, sincere opinion even being much more important than competence. He acknowledged that you need to be able to trust the AC and the members need to have an uncompromised track record.

Understanding the environment in which they serve as AC members were also considered to be one of the top six characteristics by participants.

The MM at MUN6 summarise the top six characteristics, namely understanding the environment, credibility and integrity, leadership, and independence, not being easily influenced and displaying a strong personality in the following quote:

*... obviously, they need to have an understanding of the environment that we're operating in, inclusive of all the legislation ..., they should have clout if I can put it that way within the communities that they're staying in and then I think it's also, they need to be leaders as well, and show good leadership. To make sure that they ... they don't get influenced by ... stuff coming in from the side-line. They need to be focused, stay focused on what is on the agenda and I think for me, they need to be able to instil trust and respect. Because if those things are not there, I don't think you can have a committee that's going to add value. ... those are the most important ones that I think that should be there.*

Leadership was identified in the top six characteristics of effective ACs by participants. The MM at MUN2 stated the following about leadership:

*For me, in any situation, the issue of leadership is important. You know, by the way someone expresses himself, will tell you whether that person possesses leadership, in the way he engages with issues, you know? Sometime people respond emotionally to an issue that doesn't require emotion. You know? And sometimes people are unable to deal with the actual issue in terms of dealing with side issues. And I think from the audit committee point of view, I think those guys know what they want. .... They know what they are supposed to come and do, and they just do that. And they provide leadership most important in terms of how those things should be executed and engaging with them... the most important thing they are governance orientated. As far as I am concerned, and the next thing is that I think there is tremendous good leadership capabilities that is being demonstrated.*

The critical role the ACC plays, and the leadership behaviour of the ACC was also recognised in previous research and by various participants in this research.

The MM at MUN5 acknowledged that the ACC plays a significant role and needs to have good facilitating skills and have the necessary expertise but should know the boundaries and the limits.

*The chairperson I think is very important. For the chairperson to lead from the front and make sure that issues get on the agenda that is really of importance to the municipality and ... to them as an audit committee, I think the chairperson is vital in that sense, to make sure that the meetings are run properly, to ensure that people actually do spend time preparing, and to also play a thorough, like the mediator role between you, know the committee and council or the municipality. So ... in that sense I think it's probably the person that would need the most experience in those type of things, but also have a good understanding of municipal finance and municipal legislation in general. Because we're so overregulated. We need a chairperson that actually understands that and not, you know play the role of or want to play the role of a judge and not you know, understand where some of these pieces of legislation are coming from. That we are actually developmental in the wider sense than just sticking to if you come out of a business, for instance, just sticking to making sure that your finances are run properly, governance and stuff, because we've got that political interference as well. Our chairperson needs to understand all of those things to guide the whole process, or the whole committee properly (MM – MUN6).*

*I think as the chairperson you've got to drive it. You've got to drive it and he must know what he's talking about so that when other people talk, you must be able to understand whether that person is talking rubbish or not. They've got to advise council, they've got to tell me what to do, but if ridiculous discussions come out in recommendations, it's going to mean nothing, so he's got to be very knowledgeable. I think that's where a lot of the audit committees might go wrong, in that they, the audit committee is there mainly from a governance perspective to make sure governance is there. They're not there to do the financials or do that. They must see governance is in place. So, whoever is the chairperson must understand governance so that it could guide the committee in the right direction. ... And we had a – chairperson at one stage which was – he didn't have the authority, the oomph to put his foot down. Then the committee runs haywire. So, you need a very strong leader. And of course, also the other thing is being experts, they must stand up... So, you must have that robustness of being able to stand up for what you believe in. That makes strong leadership (CAE – MUN6).*

At the same municipality, all the participants recognised the critical role of the ACC and the representative of the council stated that the success of the AC could be entirely ascribed to the ACC. He based this opinion on the competence of the chair, which consequently attracts competent people to serve with him on the AC.

The CAE at MUN4 also conveyed a passionate message on the role the ACC needs to play and characteristics the person should demonstrate:

*[I mean our audit committee is very robust. The ACC would not hesitate to go to the offices of the Auditor-General to speak to them, or he calls people in to the meeting to explain matters. That type of thing. So, they are very serious about their roles and responsibilities. They don't stand back, and that is why you need a strong personality in the ACC]*

The CAE stipulated the following required characteristics for the ACC:

*Well, audit committee chair is for me someone that can display leadership. Conflict management and how to get people with divergent views on a specific level and the audit committee in terms of the skillset and the qualifications, look what is important for them. Firstly that that they are in an advisory capacity and as such audit committee members should be able to communicate and advise the necessary role players including the CAE, management and also council.*

The mayor at MUN5 stated:

*In the chairperson, I would, in addition ... the ability of coordinating the activities of the committee and then interacting not only with his own committee but also with the members of administration that attend the meetings.*

The mayor, MM and CFO at MUN7 agreed that the ACC plays a critical role and needs to be a good facilitator, have knowledge in all the areas including local government and applicable legislation, and be able to manage the members of the municipality and the AC. The MM also mentioned there are sometimes difficult situations in which the ACC needs to take control. The CAE at the same municipality believed that guidance, time management, and focus by the ACC is very important.

A chairperson also needs to be capable to manage group dynamics including different contributions and conflict and be able to use the competence of the whole team by actively involving them (MUN4 - CFO).

## Concluding observations – Characteristics of AC members and Chair

Important characteristics of AC members and the ACC were identified by participants in the first place to display a strong personality and actions together with honesty and integrity in fulfilling their responsibilities. Part of demonstrating a strong personality would be to interrogate by way of challenging, context-based questions and deal with the issues constructively. Independence and objectivity were also considered to be important characteristics. The participants further considered leadership, not being easily influenced, and understanding local government environment to be key. These required characteristics identified by participants showed similarity to those characteristics identified in other research on AC effectiveness.

Various characteristics of the AC members and the ACC impact on perceived effectiveness. It was not possible through this research to demonstrate a direct link between these characteristics and audit outcomes. However, what became evident during discussions was, through interrogating questions and analysis matters that could result in negative audit outcomes and findings are highlighted. Furthermore, strong ACCs played an important role as part of resolving disagreements that could have resulted in negative audit outcomes.

### 7.4.2.4 Independence

Independence and objectivity were rated the second highest priority characteristic by participants in this study for AC members to possess. Throughout the literature, reference was made to the importance of AC members being independent as a construct of effectiveness. The legislative requirements for ACs within the South African local government context (MFMA) states that AC members should not be in the employ of the municipality and must be appointed by the council, assuming that this would ensure independence. Determining whether the municipality does not employ AC members would have been a typical measurement used during archival studies. However, by using the interview method, the researcher was able to explore possible subtle threats to AC independence, such as close relationships or associations between the AC members and management and politicians.

AC composition and independence and the relevant research is described in section 5.5. Independence means acting and appearing to be objective and not being influenced by management, auditors, or politicians. The King IV also recognises independence in appearance is one element in the composition of the governing body. The overriding concern

is whether the governing body is sufficiently knowledgeable, skilled, experienced, diverse, and independent to discharge its governance role and responsibilities fully (IODSA, 2016:28). Related to the AC, the King IV requires that all AC members, including the chairperson, be an independent, non-executive member of the governing body (IODSA, 2016:56).

At both MUN1 and MUN2 mention was made of the importance of AC members being A-political. Other participants' views on independence were as follows:

At MUN4 the mayor re-emphasised the importance of independence and for the AC not to move too close to the politicians or administration. To him, being honest and sincere and independent were even more important than competence.

The MM at MUN5 also felt strongly about the independence and said unless the AC is unequivocal independent, it is no use to have an AC.

The ACC at the same municipality shared this view:

*The other thing is the issue of being independent, independence and objectivity, those are the two main characteristics. Sometimes you do find that audit committee members are biased, they've got their own side agendas, or preferences and those can sometimes come out in meetings. So, I think that it's very important that you must try to be as objective as possible and independent for the organisation. Professionalism. That is of the utmost importance. You do sometimes get people who start to have a casual relationship with management or some of the officials and that sometimes compromise your position.*

As indicated under the heading of 'The appointment process', some members serving on ACs have been approached because they were recommended by other AC members or management or because they were originally from the specific town or region. In other cases, during the interviews, it was shared that AC members or ACCs were known to management due to growing up together or being previous work colleagues. Despite the possibility that it could be perceived to impact on independence, responses to the question raised by the researcher on how independence is ensured indicated various measures being put in place.

Firstly, the MFMA legislative requirement in section 166(4) prohibits AC members from being in the employment of the municipality. Secondly, the rigorous and transparent appointment process and confirmation required during interviews to serve on ACs that there are no conflicts of interest are further measures. Another measure to address independence is the statement in AC charters on independence. Four of the six charters reviewed included a specific independence statement of some sort and the other two municipalities referred to the



composition of the AC comprising of independent members. An example of an independent statement in one of the AC charters reads as follows:

In order to be effective, the [audit committee] will be independent and safeguarded from any undue influence in exercising its responsibilities in an objective manner. To enhance the [audit committee] functioning, the following will be required:

- ... the [audit committee] chairperson and members must be independent of the municipality.
- ... the [audit committee] chairperson and members shall not be biased but exhibit an independence of mental attitude during deliberations.
- ... all [audit committee] members must declare private and business interest relevant to the subject matter (s) of the meeting at *every meeting*; and
- ... all [ audit committee] members shall not carry out any business with the municipality.

A fourth mitigation presented referred to the annual declaration where any business interests need to be declared as well as at every AC meeting where members are required to sign a declaration of non-interest. The AC members are also prohibited from carrying out any business, other than serving on the AC, with the municipality.

A review of the agendas and minutes of meetings indicated that at each of the municipalities, a declaration of interest formed part of the agenda and/or minutes or the attendance register signed referred to the declaration of interest.

At one of the municipalities, the annual report listed the position of an AC member in various businesses. This is a form of transparency and a good praxis to demonstrate independence.

Another measure that was put forward as a mitigating step was scrutiny of CVs for possible conflict of interest. Lastly, some of the participants observed that independence could be noted during interactions with the AC.

However, the measures taken to ensure independence was considered by some participants not to be rigorous enough. One of the CAEs felt the process could be improved:

*We, by way of CVs. We will pick up if there's involvement in the things that we're not sure of or whatever. That is maybe an area that we can maybe enhance, how do we ensure that [independence]. That came out in the recent survey as well. About that independence and I also realised maybe we should look at our charter again. I'm not sure to what extent it states it there. I don't think it's robust enough. So far we've been very lucky that we make sure*

*through the chairperson who knows everybody in the country. Whether this guy is independent or not.*

Another safeguard for independence is related to the tenure of serving on an AC as prescribed in Circular 65 that prohibits an AC member from serving as an AC member for a period longer than two terms (six years). An example from an AC charter on the restriction reads as follows: The chairperson shall be appointed for a minimum of three (3) years to ensure that he/she contributes most effectively and provides stability to the [audit committee].

Other [audit committee] members should serve at least a minimum of three (3) years with the option by the council to renew the term for another three (3) years, based on performance of the member.

The term of office of any [audit committee] member must not exceed two (2) consecutive terms of three (3) years each. ...

After serving consecutively for six (6) years, a cooling off period of two (2) years should be applied before re-appointing the same member to the [audit committee].

At all the municipalities the AC charters reviewed included a section on tenure in compliance with circular 65 that prescribes a maximum tenure of six years. Only one of the municipalities included a clause on the cooling-off period.

However, in light of the challenges in obtaining skilled, experienced, and willing members to serve on AC, this restriction is considered inappropriate by some of the members although they understand, acknowledged, and agreed with the reason (independence).

*... when you need to replace a member, sometimes you feel you are just getting up to the right point now [of the relationship]. That type of thing, because we build on that relationship and it's always difficult to find a replacement. It's also good because you don't want a situation where you are seen to be friends, and therefore you cannot make an objective decision or give objective advice because you are friends with the Municipal Manager. (MUN6 – MM)*

Given the challenges experienced in recruiting people with adequate experience and expertise, especially at rural municipalities and the need for this expertise, the question should be raised whether obtaining experience and expertise is not more important than formal independence. Another question is whether the current restrictions on a maximum tenure of six years and members being allowed to only serve on three ACs are appropriate given the current challenges on recruitment. Would it be sufficient for the AC to demonstrate independence by way of their actions and interactions during contact with members of the municipality, including politicians together with the other mitigating factors referred to above? Further research would be necessary in this area.

### **Fieldwork praxis tips**

- Provide for cooling off period after 2nd term of appointment.
- Disclose business interests of AC members as part of AR.

### **Concluding observations – Independence**

Independence and objectivity were recognised as some of the most important characteristics of AC members and the ACC. The difficulty in recruiting skilled and competent members to the AC at rural municipalities have necessitated approaching AC members to identify possible recruits and approaching previous colleagues and acquaintances to serve on ACs. Although this may pose a threat to independence, various mitigating factors have been identified. According to legislation, AC members must not be employed by the municipality. Another mitigating factor is the rigorous and transparent appointment process where the ultimate approval lies with the council. All of the cases referred to the independence of AC members in the AC charters and AC members are required to make and sign a declaration of interests at every AC meeting.

The tenure restriction of a maximum of two terms further supports the independence of AC members.

Although cases in this study presented favourable and less favourable audit outcomes, independence of audit committees appeared not to have played a role in the audit outcomes.

An analysis of the diligence of AC members as a determinant of effectiveness in the cases of this research is covered under the next heading 'Diligence'.

#### 7.4.2.5 Diligence

The effectiveness of ACs have also been associated with the diligence of the AC members in fulfilling their roles and responsibilities in both the research and the results of this study. Diligence has been explained by referring to commitment, dedication, and willingness to devote time and energy evident by attendance, preparation and participation at meetings and following up on important areas.

A frequent measurement of diligence (refer to section 5.8) is the number of meetings held and attended by AC members. According to research, regular meetings result in various benefits to the entity, amongst other things, a better communication between the AC and other role-players. However, the frequency of meetings is not necessarily the best measurement of diligence as it does not measure the quality or nature of interactions between the AC and the attendees at the meeting. The asking of good and interrogating questions is discussed under the characteristics of AC members under the heading 'Experience and expertise of audit committee members'.

This section presents the results of this research reflecting on the number of meetings and attendance by AC members and the views on preparation and participation at meetings, including following up on important areas. More information on formal and informal interactions between the AC and other role-players is also presented under the headings 'Formal meetings' and 'Informal interactions'.

This section also reflects the different views on the remuneration paid to AC members and the possible impact on diligence and the ability to recruit the necessary capacity at municipalities, especially at rural municipalities, discussed as part of the appointment process).

The views on time availability of AC members linked to other responsibilities, including serving on multiple ACs are also reflected on.

The number of meetings held and attended by AC members are reflected in some of the AC reports included in the annual report. Table 7.6 presents the number of AC meetings and the average percentage attendance by members per municipality.

Based on the percentages reflected in Table 7.6, meeting attendance, where information was available, appears to be reasonably high. The low rate of attendance at MUN1 can be

explained in that the one member resigned during the year and did not attend all meetings before his resignation.

**Table 7.6: Summary of frequency and attendance for sample municipalities**

	MUN1	MUN2	MUN3	MUN4	MUN5	MUN6	MUN7
Number of meetings	6	6	Not available	6	5	5	4
Attendance percentage by members	66%	100%	-	Information not provided in AR	Information not provided in AR	92%	100%

Although the number and frequency of meetings were not perceived to be a challenge at any of the cases, one ACC referred to another example of a municipality with which he is involved where the MM insists on only having the required quarterly meetings. Consequently, important functions that the AC members should be involved with are not effectively performed if they do not fall within the pre-scheduled meeting dates.

*This comes back to the point where I said the agendas get overloaded, so the frequency of the meetings, generally once a quarter but there are additional meetings that we should schedule for specific things, for instance your audit plans, the review of the financial statement, meetings with the AG and if I compare it with [this municipality] we are able to have those meetings. We probably have six or seven meetings, what they call compulsory meetings per year. If I compare that with ... we should have one meeting per quarter, and then end up sometimes not having some of these [meetings], for instance, because of the fact that the meeting doesn't fit in with the schedule of the AG you don't even see the management report for that matter, or the final audit report. Yes, it was sent to the chair, but you get sent an email and said to email your comments back, so there is a total difference between that and the audit committee of .... There is sometimes a problem with the frequency of meetings, the agenda being overloaded ... and that's purely because of the fact that, they want to save on costs.*

The MM at MUN1 and CAE at MUN5 also equate diligence to the initiative of the AC members to call for meetings when necessary and then making themselves available for these meetings. The CAE at the same municipality measured diligence by the extent to which AC members prepare for meetings.

However, as previously recognised, the measurement of diligence should not be restricted to the frequency of meetings; the quality or nature of interactions should also be measured. The

importance of asking interrogating questions is discussed under the heading 'Characteristics of members and the chairperson'.

Several participants linked demonstrating diligence to interaction and contributions at the AC meetings.

The MM at one of the municipalities in the Western Cape said the AC members all attend meetings, are well-prepared, and the chairperson coordinates the inputs of all the AC members. The MM explained the ACC allocates different areas of the agenda to individual AC members according to their areas of expertise. Individual members then provide input and pose questions during the meeting. This praxis forces members to both prepare adequately and participate during meetings. The ACC still comes to the meeting with the overall picture and is well-prepared.

A similar practice was followed by one of the municipalities in the Northern Cape where the AC members also studied various areas of the information pack and through corresponding with each other before the meeting, ensured everybody is involved and participated and the members communicate a consistent message.

The ACC at MUN5 stated:

*... [diligence is] where you can see it is, the contribution that they make in the meeting. You know. I think that, that's the only way that we can assess that and – it would be nice if – at the meeting, each person has – aired their views on things and contributed something constructively to the meeting.*

The CAE expressed the same sentiment at MUN4:

*[You just have to attend a meeting. Where they discuss the audit reports. ... Then you easily realise this person only counts beans, he is just correcting spelling mistakes. But another person will really interrogate the report and wants to know what the root causes are. Why did something happen? How are you going to correct it? So that is the way you see it [diligence] when you attend meetings].*

The CFO at the municipality also commended the AC on a streamlined process and ascribed it to the ACC serving the second term with a good understanding of the municipality and the shortcomings, possessing good knowledge, and coming to the meeting well-prepared.

Unfortunately, this is not true in all cases. Several of the municipalities stated that although some members were prepared, participated actively, and contributed, other members were not and did not.

The mayor at MUN4 said some of his colleagues in local government told him that there are members that serve on the AC that have not said a word for two years while serving on the AC.

The MM at MUN4 sketched the situation of non-preparation of some members as follows:

*There's my briefcase, ... And they sit down and – and they're talking to you, meetings are going to start. You know what happens, they now only open the agenda. How many times have you seen that? It's become a hobby at the meeting, I spot it a mile away. And then they start speaking with authority, and I'm looking and thinking you never read that, you just opened it up. I don't get that at all.*

The mayor at MUN5 commented as follows:

*I must say that our audit committee members come to the meetings well prepared with the possible exception of the one. There's always going to be someone that's not. ... but the rest of them certainly come prepared. You can see they worked through the documents. Some of them even coming down to correct the grammar in some of the items.*

The ACC at MUN6 said he wants commitment from the AC members that they will attend meetings and understand the pack information. However, some members only highlight commas and full stops with zero contributions to the meetings. The ACC even referred to an example at a previous AC where one member made no contribution in the three years the ACC was involved.

The CFO at MUN2 also expressed the need for an increasingly thorough interrogation of in-year financial reports than what was currently performed by the AC.

The CFO at MUN7 also indicated that diligence could be measured on how well-prepared the AC members are when they attend AC meetings.

There was a difference of opinion between the CAE and CFO at MUN2 on the demonstration of diligence through the interrogation of reports. The CAE believed that diligence was observed in the extent to which the AC interrogate the internal audit reports and how they pose questions on the financial report that showed they worked through the reports thoroughly. However, the CFO at MUN2 conveyed a slightly different experience. The CFO stated that the AC needed to work more diligently through the reports because officials within the municipality still got away with a lot of things that they should not. One of the possible reasons for the lack



of adequately preparing and addressing and interrogating reports was given that the AC members were business people with their own work priorities. The CFO also suggested better interrogation and communication before the meeting to assist the AC members in preparing for the meeting. In cases like these, the difference in opinions should/could have been reflected during the performance evaluations (covered in section 7.4.3.3) of AC members. The expectation gap could be identified and discussed, and a way forward agreed upon.

Another area where diligence is demonstrated is the extent to which there is follow-up on recommendations made by the AC and the recommendations made by internal and external audit (refer to discussion under the heading 'Roles and responsibilities'). The CAE at MUN2 explained how the AC would follow up on areas of non-performance in directorates until they were satisfied that the risk was adequately addressed. At MUN2, the annual report also contained detailed recommendations from the AC per directorate and per section with an indication of whether it has been implemented. The CAE at MUN4 also explained the ACC keeps a detailed record of outstanding matters and follows it up meticulously.

The review of the agendas and minutes of meetings at all the cases where information was provided indicated follow-up on matters arising.

On the remuneration of ACs, mixed views were expressed. On the one hand, some participants believed that given the expertise and the time commitment, it is only reasonable that AC members should be fairly remunerated. The other school of thought felt one should not serve on ACs for the remuneration so it should not have an impact on diligence and time commitment. The different views of participants are further discussed.

The CFO at MUN2 believed that AC members devote their time to assist the municipality and should be remunerated but according to the tariffs as set out by National Treasury.

The CAE at the same municipality appealed for the review of circular 65 especially because of the significant challenge of scarcity of skills and experience to allow for good government employees in the area, to be used as AC members.

*[And you can't expect them to work for free giving the time required. Not so much for attending the meeting but for preparation time].*

All ACCs interviewed expressed their concern about the low remuneration. The ACCs at MUN6 and MUN7 stated that the main contributing factor to the challenge in attracting professional people to serve on the ACs at municipalities was the low remuneration paid by the municipalities. Even if the rate is compared to what is offered at provincial departments to

serve on ACs or the Auditor-General rates, there is a considerable discrepancy. Members serve on ACs because they have an interest in the local environment, for example own property, or they consider it to be part of their social responsibility; however, these reasons would not necessarily ensure sustainability in attracting and retaining AC members at the current rate of remuneration.

The one ACC was also of the opinion that ACs in the public sector should be professionalised similar to the requirements in the private sector where AC members are registered as members of the Institute of Directors. For example, there could be a requirement for AC members in the public sector to be members of the PSACF where eligibility requirements need to be adhered to, for example, minimum competency levels and professional development requirements.

The ACC at MUN5 in linking diligence to remuneration argued as follows:

*That [diligence] differs from person to person, but I personally try to make time available for the audit committee. So personally, I think I've got sufficient time. But then it comes to what you have to sacrifice to spend the time, maybe that is where, when you compare remuneration of audit committees in local government ... vs audit committees in provincial and national departments then it's very low in comparison to that. You know ... that also then impacts on the commitment of the audit committee members. Because you find that a lot of the audit committee members, maybe are self-employed or consultants so then they decide where they're going to spend their time and if you are paying R300 an hour for preparation time, you might find that the audit committee member is not going to say that, but in practice, he's not going to prioritise preparation. You might find that he prepares the night before the time, because of the fact that he doesn't get remunerated. ... So I think that is something that does impact, and yes, in general, you find that your audit committee members do prepare for meetings and I have seen instances where – you can see this person runs this meeting and he didn't even open that pack, so it does happen sometimes.*

According to the CAE commitment and diligence means serving on the AC for the right reason and not for the status or the remuneration (a sentiment shared by the Mayor at MUN7). The CAE expressed his view as follows:

*...being there for the right reasons. I'm not doing it to put it on my CV. I do it because it's my municipality or I feel I can make a contribution. The one guy who is not, he doesn't live near or have a holiday home in this area, it's the only guy that doesn't have local vested interest, but he serves on a number of local government committees. Because he says, I see what is happening in the country on a local government level. I am also a ratepayer in Cape Town,*

*but I see what's happening, and we can't carry on like this. So, he wants to be here. He's never complained about pay or anything ... and the distance as well, he says, I don't have a holiday home here, I don't have people here, I don't have friends here but I'm here to help this municipality - that is commitment for the right reason. Money mustn't count. Remuneration – it doesn't pay a lot.*

The importance of balancing remuneration with the personal exposure to reputational loss, the extensive workload and having limited direct influence was also acknowledged in the research by Roberts (2016). The impact of low remuneration on the ability to attract and recruit well-qualified AC members with the required skills and experience in South Africa was also identified in the research by Van Der Nest (2006:216-217) and shared by some of the respondents and interviewees that formed part of this study.

Remuneration of ACs, together with the challenges of getting the required well-qualified and competent AC members at local government, especially at rural municipalities, would need to be reviewed. Some research suggests (see Chapter 2) that AC members should be paid at a level that reflects the time it takes to carry out their duties with an allowance for particular skills brought to the committee.

The time AC members have available and the time spent before and after the meetings was another important discussion point under diligence.

The CFO at MUN7 believed the AC members could only fulfil their responsibilities if the municipality allows enough time for them to perform their functions. Another pre-condition, according to him, was the provision of quality documents provided by the municipality to enable the AC to provide proper advice. By referring to the overview of the financial statements, specifically, the CFO was of the view that not enough time is currently given to the AC to perform their role of review effectively.

One factor that could impact on time availability is the extent to which AC members have other work- or business-related responsibilities and serving on multiple ACs. Legislation is not prescriptive on the number of ACs' members can serve on, however, circular 65 suggests a maximum of three. This is an area of debate in the academia and practice with mixed results where some consider that serving on multiple ACs brings benefits including the best practice of other municipalities to municipalities. Those against serving on multiple ACs argue that it impacts on time availability. Some participants found this limitation to only serve on three local government ACs to be unnecessarily restrictive in an already small pool of available and willing

competent potential AC members. The restriction to only serve on three ACs is a blanket restriction without necessarily taking the specific circumstances of the potential AC members into account. For example, it could be that the prospective member is retired with fewer business interests and therefore more available time than another potential member who is employed full-time.

At one of the municipalities the CAE expressed concern about the promptness of responses and submission of reports by the ACC and that the CAE almost have to plead to get information from the ACC. She believed this was as a result of the ACC serving on various ACs not always having the time to respond timeously.

### **My story on diligence**

Unfortunately, I share the same view of some participants. Throughout my 'career' as an AC member, I often felt very frustrated towards some of the AC members forming part of the committee where there were clear signs the members did not prepare for the meeting. This could be observed through subtle signs, including not asking one question during the whole meeting or not making one single comment or contribution. Other signs would be to ask for documentation or clarification on matters where the information was included in the pack, and the member, if prepared properly, would not have asked the question or clarification.

This lack of participation also puts pressure on the ACC, who is sometimes the only 'voice' during the meetings. In general, members prepare and share some insights, but there is usually one member that demonstrates a lack of diligence.

One way to address this that works in practice and has been implemented by some of the ACCs in this study is to allocate sections of the agenda based on the specialities of the individual members and request them to lead the discussion in these areas at the meeting.

Another avenue which is not used optimally is the current performance evaluation of AC members (see section 7.4.3.3).

The ACC, MM (that is actively involved at meetings and otherwise) and management should use these evaluations to evaluate performance honestly and provide feed-back and opportunity for discussion and corrective actions.

I think one of the main reasons the performance evaluations are not used as a medium to address low-performing AC members could again be the lack of access to skilled and competent members. So instead of taking remedial actions, the situation of the one member of the AC not performing is ignored to comply with the required minimum number of members. Due to the performance of the ACC and other members, the municipality is still benefitting from an active AC, so they let it 'slip'.

At one municipality with which I was involved (not a case study municipality), I experienced first-hand how adequate and honest performance evaluations resulted in non-performing AC members not being re-elected for a second term. This was because of a strong ACC, honest assessments by management, and open discussions about performance. However difficult this might be, it seems worthwhile to implement.

## Concluding observations – Diligence

Diligence can be measured by the number of meetings (not the ideal measurement) and attendance, preparation for the meetings, and participation at the meetings

The attendance and frequency of AC meetings of the cases in this research generally demonstrated diligence. Diligence is also demonstrated through preparedness and participation during the meetings. Although in general, there seemed to be good participation and contribution by the majority of members at the meetings, examples of some members not actively participating or contributing were mentioned. In this regard, performance evaluation of individual AC members and honest feed-back becomes important.

A praxis also implemented in some of the cases is to allocate specific parts of the AC agenda to individual members based on their area of expertise, with this member being responsible for posing questions and discussion on that particular area during the meeting.

Remuneration of AC members have been indicated as a variable that could affect diligence. Another variable of diligence relates to time availability of AC members. Time availability can be impacted by other professional responsibilities and serving on multiple ACs or boards. Participants expressed mixed views on AC remuneration and serving on multiple ACs.

Reflecting on the link between AC diligence and audit outcomes it was observed at some of the municipalities, as a possible result of involvement with multiple audit committees or other business interests, AC members' contribution to limit or reduce audit findings could be restricted to some extent.

The next subsection provides information on the roles and responsibilities of ACS and the perception of the participants on what, if any, should be the priority focus area for ACs.

### 7.4.3 Roles and responsibilities

Chapter 4 provides a detailed analysis of the extent and variety of roles and responsibilities of ACs, reflected in legislation, corporate governance guidelines and research. This section provides a summary of the views of the participants on those areas of AC responsibilities that are considered to be important within the specific context of the municipality in relation to what is required of ACs in terms of legislation, best practice, and the expectations of stakeholders. This subsection also presents the view on a ceremonial versus a substantive role of ACs and concludes on the current practices of evaluating the performance of AC members.

During the fieldwork, it was not the intention to discuss each area of responsibility in detail but rather to obtain the view of the participants on those areas deemed to be important and actual performance of AC members in those areas considered to be important. As part of the analysis of roles and responsibilities, the various roles and responsibilities identified in the AC charters and reflected in the agendas and minutes of AC meetings were referred to. As correctly identified by one of the ACC, the agenda needs to be structured around the areas of responsibilities. As part of the fulfilment of responsibilities, reference was also made to the AC reports included in the annual reports. Under the next heading of 'Roles and responsibilities' the fieldwork findings of those areas considered to be important as part of the roles and responsibilities of ACs at the different cases are presented.

#### *7.4.3.1 Roles and responsibilities*

During the fieldwork, the participants were presented with a list of possible focus areas of ACs. They were asked if any of the areas are considered to be more important than others within the municipal context. The participants were also encouraged to discuss the role the AC plays or should be playing in the areas considered to be important to the participants.

The key areas of responsibilities explored include overseeing and providing advice on governance, the financial reporting process and financial information, internal control, internal and external audit, risk management, performance management, compliance, ethics, and combined assurance.

The majority of the participants indicated all areas are important and did not specifically elevate a specific area (MUN1 – MM and CAE; MUN2 – MM, ACC and CAE; MUN4 – CAE; MUN5 – MM and CAE; MUN6 – Mayor, CFO and CAE; MUN7 – MM and CAE). However, some participants believed some areas were more important and needed extra attention by AC members, including performance management, IT, risk management, compliance, ethics, and combined assurance and are further explored.

The MM at MUN1 believed that there is not a specific priority area, but rather the focus should be on all matters to make sure the taxpayers' money is applied appropriately. The CAE at MUN1 concurred that all areas are important and forms part of the standing agenda points. The review of an agenda of a meeting at MUN1 confirmed this statement. All areas were indicated on the agenda except for having a separate heading for combined assurance. However, the AC charter referred to the role of the AC in combined assurance. The AC did not report on the area of combined assurance and the responsibilities of the AC in this regard.



The ACC at MUN2:

*[All areas are important to work towards the ultimate goal of a clean audit.]*

A review of the minutes of the AC reflected a significant focus during the AC meetings on the internal audit reports, confirming what other participants at this municipality stated and confirming the attention given to the control environment.

The MM at MUN4 explained the AC involvement in the whole process as follows:

*The chairperson of the audit committee also sits on our performance evaluations, performance evaluations of mine and my section 57s. Now that is a very good return on investment. Let's see the linkages here ... [the chairperson] at the beginning of the cycle sits in on the strategic workshop with the councillors. We bear ourselves to him, he can see where we're going to spend our money, ..., is there fall out between the councillors, is there dissatisfaction, so he's getting a very good idea. Then as the year goes on he's getting these reports that he asks for that he can interrogate, that he can explore, that he can keep up to date ... so he can see how the jumbo is flying and then he comes in twice a year on a performance [evaluation] of the municipal manager and the section 57s. To actually see the KPAs these guys have got. Let me see does it fit with what we're dealing with in the strategic plan, does it fit what came up in the audit committee? So, we've got a reiterative cycle. I think that's a very good concept.*

The agenda and minutes of the AC meetings demonstrated focus during the meetings on external audit findings, internal audit findings, risk management, performance management, finances, and IT.

The MM at MUN5:

*[In my organisation, everything done play a role. ... if there is damage in one area it is the weak link in the chain.]*

A review of the agenda for a meeting indicate standing items include external audit, internal audit, risk management, performance management, finances, and MSCOA implementation.

The MM at MUN6 believed the area the AC would focus on depends on where the municipality is at, at the time and the AC would focus on high-risk or problem areas. This implies that the area of focus could continuously change.

*I think it depends on where your municipality is currently at, and that's why I think the audit committee also needs to be adaptive to interrogate and to discuss what is happening within the municipality at the present time. If finances and stuff are bad and those type of things, then that needs to be the focus. Is the finance management system actually working properly, are you collecting all the money that you should be, is there a problem with billing or whatever that impacts on the finances? But I think they need to be adaptive to that as well, and I think in our*

*case, it is the case to some extent that they tend to focus on issues that are currently an issue. ..., we, for instance had an issue with risk management at some stage and they actually assisted us with some of that.*

The representative of the council for the same municipality confirmed the view of the MM and indicated all areas are important if the municipality is in a stable position. But when the municipality had a problem with risk management, the AC assisted, and risk management issues were addressed. A similar sentiment was expressed by the mayor at MUN5 where the mayor believed the AC plays a very balanced role but focussed on risk management when the municipality had a challenge in this area. The CAE also stated the focus depends on the risk profile and what has been reported by the AGSA and internal audit on control weaknesses.

The agenda at MUN6 indicated a focus on external audit, internal audit, risk management, finance, MSCOA, IT, and combined assurance.

The agenda and minutes at MUN7 also indicated comprehensive coverage of all the areas. Key focus areas of the AC are related to the specific context of the municipality, although some transversal focus areas also exist.

What became apparent during the discussions and review of the agenda and minutes of meetings of the cases was that the area of overseeing and providing advice on the financial reporting processes and financial information is considered a high-priority area for ACs. The focus is in line with results of other research on AC effectiveness presented in Chapter 2. The emphasis on obtaining clean audit opinions and the role the AC plays in the municipalities achieving positive audit outcomes is a further indication that AC in local government plays a significant role in overseeing the financial processes and financial information. The following table provides an overview of the areas of responsibility relating to the financial overview covered in AC charters:

An analysis of the information in Table 7.7 demonstrates the extensive and comprehensive responsibilities of the AC related to the financial environment covered in the AC charters, the focus being on the review of the content of the financial statements. One of the municipalities (MUN1) also included the review of the quarterly financial information as part of the AC responsibilities in the charter. Although reviewing in-year financial reports is considered an important responsibility of the AC, only two of the six AC reports reviewed referred to this area of responsibility in the AC reports.

**Table 7.7: Summary of audit committee responsibilities per Audit Committee Charters on the area of finances**

Area of responsibility on finances	MUN1	MUN4	MUN5	MUN6	MUN7
Review FS for compliance with standards, legal framework and reasonableness, completeness and accuracy and provide timely comments.	√	√	√	√	√
Provide an authoritative and credible view of financial position.	√	√	√	√	√
Review the appropriateness of accounting policies.	√	√	√	√	√
Review appropriateness of significant estimates and judgements.	√	√	√	√	√
Review methods used to account for, impact, and disclosure of significant or unusual transactions that are open to different interpretations.	√	x	√	√	√
Review clarity and quality of disclosures.	√	x	√	√	√
Review efficiency and effectiveness of internal controls over FS preparation and reporting.	√	√	√	x	√
All material issues in prior reports by AGSA properly accounted for.	√	√	√	√	√
Conduct analysis of trends and ratio analysis.	x	√	√	√	√

One difference between the various AC charters identified related to the reviewing of unaudited, versus audited financial statements. The AC charters of MUN 1, MUN5, MUN6, and MUN7 refer to the review of unaudited financial statements, MUN2 do not specify audited or unaudited and the AC charter of MUN4 refers to audited financial statements in the AC charter before submission to and approval by council. The charter for MUN7 also includes for the AC to review litigation matters, the MM statement on internal control in the AR, and other sections of the AR for accuracy and completeness of information, as well as the audit file to ensure it complies with standards.

The charter at MUN2 does not provide as much as information as contained in the other charters. However, the MM at MUN2 specifically mentioned the active involvement of the AC with the review of the financial statements and making comments. In this regard, the AC also engaged with the Auditor-General on areas where they did not agree.

The CFO (MUN4) explained the important role of the AC in the review of the financial statements as follows:

*The chairperson is very up to date in terms of local government, finances and ... even some of the other members as well. ...they also assess it [financial statements] independently ... when we submit, and then we engage and discuss the financial statements. They will make sure that we adhere to certain of the GRAP standards, ... we have to give explanation to some*

*..., but really those are the things that add value to us, so it's not only to rely on what you as CFO submitted. They really interrogate the financials, they go through it, they ask a lot of questions, to say but well look at this and look at that, maybe add that or a little bit more that you have to disclose. I think that's what you appreciate. Sometimes you also say yes, but it's not always – when you are ready you will say I don't think that is the reason why we do it x, y, z. And then we will give explanations. ... For the past few years, you know we're very fortunate that we don't really have any material misstatements in terms of financial statements, and I think the Auditor-General also commended us ... So, the financial statements, what we submit is very clean, and there's no real major things that we need to do once the auditors have audited us. So, and I think they're part of that, you know, that they play a role. The way they go through it.*

The CAE at MUN6 explained the review of the financial statements:

*What happened with the last one is that the CFO would present his statements; go through, now we've got two CAs on our committee. These people know what they're talking about and then they would have the discussions... go through every single line, every single note to the financial statements, they go through it, and when we're finished the CFO actually said to me they're very robust and there's a couple of good things that came out of there that he needs to take into account.*

The ACC confirmed the extent of detail the AC go through when reviewing the financial statements. The ACC was also of the view that the AC needs to make sure the Finance section is appropriately staffed.

A need identified by some participants during the fieldwork is for the AC to become more involved from a financial management point of view, instead of just reviewing the financial statements. For example, the council representative at MUN2 indicated the need for advice on, for example, the budget and the comprehensiveness thereof, the feasibility of projects and investment decisions. Although it was recognised it is the prerogative of the mayor to compile and submit the budget the representative of the council believed that councillors were not that knowledgeable about budgets with the result that important areas could be omitted. On the other hand, the danger of this could be the perception that ACs become involved or perceive to interfere with management responsibilities.

The CFO at MUN2 also stated:

*[But it will help if the audit committee in terms of financial management could strengthen our hand. Because we report to the council and the council consists of politicians and what I found*

*the councillors vision and the administration's vision differs immensely. So many times, there are things that we do that is administratively correct but not politically. In such cases, and it comes back to the need for thorough interrogation of financial reports and that there should be detailed discussions about financial reports that the audit committee can be more informed on the financial reports and financial position of the municipality and planning. Things the administration do and in their recommendations to the council strengthen the hand of the administration. I personally feel they still run over our reports].*

The CFO at MUN4 believed that the ACs need to have their fingers on the pulse not only in terms of financial statements and the financial reporting process but also where the municipality is heading concerning the cash flow and budgets on a monthly and quarterly basis.

The CAE at MUN6 also alluded to the need for in-year monitoring of financial reports, ratios, and financial liabilities.

The CFO at MUN7 also expressed the view that the AC should play more of an advisory role taking the municipality forward by looking at strategic issues including, long-term financial liability.

During an information session for ACs attended by the researcher in 2019, the need for ACs to become more involved with financial management matters was also highlighted. Some areas suggested include advising on the strategic focus by considering the impact of the economy, pricing of services including tariff costs and whether that is reflective, working capital management, funding models and investment strategies. From another angle, however, there would need to be consultation and agreement of the extent to which the ACs would become involved, especially in light of the concerns raised by some of the participants in this research that ACs should not become involved in management matters and decision-making. At the same time, the need for advice by the AC in financial management-related matters has been expressed by a few members of the council or council representatives that formed part of this study. This needs to be further researched.

The second important role for the AC is to assist the council in monitoring by reviewing the internal control environment and the work performed by internal including the follow-up and implementation of internal audit recommendations. Internal audit focuses on the effectiveness of internal controls to mitigate risks and ensure, amongst other things, that financial reports are credible. ACs rely on the work of the internal audit to assist them in the assessment of the

effectiveness of internal control. Under the heading 'Relationships', the importance of the relationship between the AC and the IAF has been described.

During the fieldwork, a review of the AC charters of the cases provided also confirms the focus of the AC on the IAF and internal control. A comparison of the AC charters to the 10-point oversight checklist issued by the IIA in the document on Internal Audit Oversight and Table 7.8 indicates the results of the comparison.

The analysis of information in Table 7.8 reveals a high level of compliance with the IIA ten-point checklist of the AC overseeing the IAF, covered in the AC charters. Additional AC responsibilities covered in some of the charters include requesting specific audit projects where necessary and reviewing management requests for extra work in accounting and control systems (MUN5 and MUN6). All AC charters referred to the need to coordinate the work of internal audit and external audit. At MUN7 the charter also provided for the AC to oversee training to ensure compliance with the ISPPA.

The views of participants on the roles and responsibilities of the AC related to internal audit were solicited during the fieldwork. Some of the participant views on this are reflected below: The CAE at MUN1 indicated the IAF provides a weekly update to management and quarterly to the AC and management of the extent of implementation of recommendations. The same information is also provided to the AGSA. The track-keeping of implementation of internal audit recommendations is one of the key performance indicators of the CAE in the SDBIP. The following is an example of the municipality indicating the process used for follow-up.

'We would like to indicate clearly that the process to handle audit follow up is as follows:

1. Complete the audit follow up template that is in excel format.
2. Send an email by attaching the template that you have completed.
3. Clearly states in your email which numbers and period on the template did you respond on.
4. Clearly states within the email what time and date you would be able to visit internal audit for the verification of the evidence to prove that you have implemented the recommendation or an alternative...

**Table 7.8: Comparison of Audit Committee Charter responsibilities to IIA 10-point oversight checklist**

10 points/Sample municipality	MUN1	MUN2	MUN4	MUN5	MUN6	MUN7
1. Open and transparent engagement with CAE	√	√	√	√	√	√
2. Reviews and approves IA Charter annually	√	√	√	√	√	√
3. AC has a clear understanding of the strengths and weaknesses of IC and RM	√	√	√	√	√	√
4. IA Plan indicating competent resources to complete plan reviewed and approved by AC [Adapted – IIA point – Advise on resources allocated to the IAF; Confirm plan includes critical risk areas and consider changes to plan]	√	√	√	√	√	√
5. Reporting relationship ensures independence of IAF	Statement on monitor independence	Statement - ensure no limitations	Statement on ensuing independence	Statement on ensuing independence	√	√
6. AC addresses all issues relating to independence and objectivity with CAE	√	√	√	√	√	√
7. IA has QAIP in place [Adapted - IIA point to include – review results of quality assessments]	√	Statement on ensure compliance with IIA standards	x	√	√	√
8. AC regularly communicates with CAE about performance and improvement of IA	√	√	√	√	√	√
9. IA recommendations implemented by management	√	√	√	√	√	√
10. AC meets with CAE without management	√	√	√	√	√	x

At MUN2, based on the discussions with the CAE, the MM, the CFO, and the ACC it was evident that much focus is given to hold managers accountable for the implementation of internal audit recommendations. The CAE explained that there are even separate time slots (in-camera with the specific responsible manager) where that manager needs to provide feedback on progress to the AC. The CAE further stated the AC would not hesitate to send the manager back to amend their comments or give further feedback during the next meeting.

Based on personal experience, some grey areas are noticeable in the responsibilities of the AC towards the IAF. These areas are the appointment and dismissal and the performance



evaluation of the CAE. Referring to legislation providing for an advisory role, some are of the view the appointment and dismissal are administrative rather than functional, excluding the AC from being involved. On performance assessments of the CAE and IAF, recent professional opinions identified the need for a meaningful assessment of internal audit to enable improved performance. During this research, the specific role of the AC in the appointment and dismissal of the CAE and performance evaluations were not discussed in detail. However, a review of the AC charters indicated charters of all the municipalities refer to the need for the AC to evaluate the performance of the IAF. On the appointment and dismissal of the CAE, charters included various responsibilities – consultation (MUN1 and MUN5); concur (MUN4, MUN6), may recommend and be consulted with (MUN7) and review and concur (MUN2) – that indicates various practices at municipalities.

Performance management was another area that was considered to be important for some of the participants and was also identified as an area where the AC sometimes lack experience and expertise. The MM at MUN5, the CFO at MUN6, and the council representative at MUN2 indicated they would like more advice and assistance from the AC regarding performance management.

The mayor at MUN4 remarked:

*[For me, a fairly high priority, and it is for me personally, is that our audit committee chairperson also serves on the performance evaluation committee of the section 56 and 57 appointments. So, it is very important for me because that is an indication of how your municipality will perform or not. So, it is important that the person that serves should have the background to be able to assist me to do the performance evaluation of the municipal manager, and for the municipal manager if the performance of the directors are evaluated. So, it is very important for me.]*

In all the cases, the review of performance management formed part of the responsibilities of the AC except at one municipality where the same members serve, but a separate performance AC meeting is held (on the same day as the AC meeting). The reason this separation is needed, according to the explanation of the ACC, is the difference in the role the AC plays. He explained it as follows:

The AC is an official committee of the council with authority and functions that are clear. The functional mandate is straight forward and set out in the AC Charter. The charter provides the AC with specific authority, for example, to request any information required and to do special investigations and describes the appointment process of the AC. At the Performance AC meeting, the members observe and make recommendations that management can ignore.

The ACC also attends the performance evaluations of management and make recommendations. At these evaluations, the ACC make sure it is standardised. Through recommendations, the ACC has ensured top-layer KPIs are measured correctly as well as the weight allocation. The quality of information is good. CAE also needs to audit the portfolio of evidence as part of their audit plan. So, regarding performance information they can advise, based on best practice, and although it is not their mandate, the AC can influence it. His view is that performance management systems at other municipalities he is aware of are weak. Performance responsibilities are allocated to the wrong people; for example, the CFO is responsible for service delivery. He identified the need for a completely new approach away from compliance to service delivery. His view on the need for a much bigger focus on service delivery rather than compliance has been expressed by many of the participants.

The MM at MUN7 made an important observation that service delivery and the role of the AC in service delivery is not necessarily highlighted as such as part of the standing items on the agenda. Although the AC charter includes the AC responsibilities for performance management, the focus is more on compliance. The mayor at MUN7 expressed strong views on the over-emphasis on compliance rather than service delivery in general (not restricted to the AC only) and the negative impact thereof on service delivery.

An analysis of the performance management responsibilities of the AC is included in Table 7.9.

Based on the information in Table 7.9, there seems to be inconsistency in the extent AC performance management responsibilities are included in the charters. It was further noted during the analysis that some municipalities refer to *review* and some to *review and comment*. Although the AC charters did not include the responsibility of the ACC at the bi-annual performance appraisals, it was confirmed that the ACC attends this and at MUN5 the MM requests the ACC to write a report to council after the performance evaluations.

As a result of the inconsistency, a decision was made to review the disclosure in the AC reports in the area of performance management. The following information emerged:

All AC reports included a section on performance management. However, the information and type of work the AC performed differed considerably between the different municipalities. The AC at the one municipality indicated the AC reviewed the performance information and commented on the regression in performance. Another AC report only included a description of the work performed by the IAF. In contrast another AC report indicated satisfaction with processes and reporting by management, the IAF and AGSA without making any reference to

the responsibility of the AC. The AC reports of two of the six municipalities referred to the AC reviewing the quarterly reports of internal audit on performance management and the AC reviewing the actual performance of the municipality. One of the AC reports included a statement on the AC making recommendations on internal control in this area and attended to performance assessments of management.

**Table 7.9: Summary of performance management responsibilities in AC charters**

Performance management responsibilities	MUN1	MUN2	MUN4	MUN5	MUN6	MUN7
Review and comment on compliance with legislation, best practice, and PM policy	x	x	x	√	√	√
Review and comment on consistency between strategic documents and performance agreements	x	x	x	√	√	√
Review and comment on relevance and measurability of indicators	√	√	√	√	√	√
Review compliance with in-year reporting requirements	√	x	x	√	√	√
Review quarterly performance reports submitted by IA	√	√	√	√	√	√
Review and comment on the municipality's AFS and timely submission to AGSA	√	x	x	√	√	√
Review and comment on the municipality's annual report	√	x	√	√	√	√
Review and comment on the municipality's performance management system and make recommendations for improvement	√	√	√	√	√	√
Participate ACC at bi-annual performance appraisal of management team as observe	√	√	x	√	x	x
At least twice during a financial year submit a performance management report to council	√	√	√	x	x	x

In light of some of the observations that the AC lack skills and experience in the area of performance management and the need for more attention in this area, it is appropriate for careful consideration and articulation of the AC performance management responsibilities as reflected in the AC charters.

The mayor at MUN7 believed that performance management and risk management are important areas as they impact directly on financial management. He used the example of the influx of people that results in risks that impact on the financial statements.

One of the key responsibilities of the AC is to evaluate and monitor how the municipality responds to risk and the related internal controls to promote accountability and service delivery. Based on the review of the agendas and minutes of the AC meetings, it was noted

that risk management formed part of the discussions at the meetings. At all except one of the municipalities, a separate risk committee existed, and the AC played more of an oversight role. Typical responsibilities in the AC charter included reviewing the activities and the reports received from the risk committee, the process of risk management, procedures for identifying risks and controlling the impact and risk responses.

At MUN7, the AC also fulfilled the role of the risk committee with the result that the extent of risk management responsibilities included in the AC charter was more extensive. Additional responsibilities included reviewing the risk strategy, approving the Risk Management Strategic Plan, and satisfying itself of the integrity of the management control systems, including the review of policies and practices.

At MUN4, the MM considered risk management to be a particularly important part of the role of the AC:

*That's something, risk is a difficult area and it's also difficult to recruit people, particularly out into the rural areas, and those people demand a very high salary which most times is out of our perimeters. But I think it's very good to have a member of our audit committee on our risk committee at every meeting.*

The CFO at MUN6 also recognised the important role the AC plays in risk management.

*I think seeing that we are working in a changing environment, things can happen. Today it's okay, tomorrow it's not okay, so I think always to keep you on top of especially on the risk, asking the right questions, ... even from there the expertise and their exposure, they will ask are you okay with this and are you okay with this. It just starts making you think – so risk for me it's quite important.*

The CFO at MUN7 was of the view the AC should be spending more time and receive more information from management on ICT governance, disaster recovery and high-risk areas. The CAE also referred to the need for more intensive discussions on risk management.

Publications by professional bodies over the last few years and discussed in section 4.15 indicate the important role of the AC and internal audit in the process of managing IT risks and mitigating controls in a constantly changing IT environment. The role and responsibilities of the AC in the IT environment have been incorporated in all of the AC charters reviewed.

Typical IT responsibilities include overseeing and providing advice on IT governance including risks and controls, business continuity and data recovery, and information security and

privacy. To enable the AC to fulfil this function, they need to understand the overall exposure to IT risks from a municipal perspective and those areas that effective controls adequately mitigate the risks. The AGSA already identified the need for AC to pay more attention to the evaluation of IT controls in 2015 (2015:13).

It is likely, based on experience, that this is an area where ACs might need to make use of expert advice to supplement the available expertise on the AC. This study has already alluded to the challenges in obtaining AC members with the necessary skills and experience especially at rural municipalities and in the area of IT, the situation seems even more dire. Three of the six charters reviewed indicated the need for the AC to have IT skills as part of the complete skills set of the AC. All but one charter made provision for the AC to obtain IT expertise within or outside the municipality if required. A challenge might be the cost implications and the need to have the expertise acquired through the normal municipal supply chain procedures and approval that might pose a challenge, especially in light of cost containment measures.

The ACC at MUN6 recognised ICT skills is a major problem at municipalities. The MM at MUN5 also shared that they once had a member with IT skills on the AC, but the person did not serve for long due to the challenges of travelling.

Researchers such as Marx and Els raised their concerns about the significant number of ACs not reviewing compliance with the code of ethics and the annual AC reports lacking information on the AC activities related to ethics management. They also recommended the AC should consider the need for ethics audits to be performed from time to time (2009:8). This prompted further analysis as part of this research, although ethics management did not feature prominently during the discussions. The ACC at MUN5 identified ethics, ICT, and compliance to be issues on which ACs could focus.

From the analysis of the AC charters of the cases reviewed, the following was observed: four of the six charters referred to the AC responsibilities on ethics management. However, the requirements differed between municipalities. MUN4 require of the AC to review statements on ethical standards and assist the council in developing standards and requirements. It is further required of the AC to make recommendations on potential conflict of interest or questionable situations of a material nature. MUN5 address the responsibilities under the internal control environment area of responsibility and require of the AC to assess the steps taken by management to encourage ethical and lawful behaviour for the use of public resources. For MUN1 and MUN6, the responsibilities included reviewing policy documents incorporating ethics, monitoring the compliance, and taking note of significant cases of

misconduct and the resolution of the cases. From the different responsibilities and emphasis on ethics in the AC charters it is an area that might need further research to establish the responsibilities of the AC related to ethics and ethics management.

Review of the AC reports on ethics management indicate similar findings to those of Marx and Els on the annual AC reports lacking information on the AC activities related to ethics management. Not one of the six AC reports included information on the role of the AC on ethics management.

Closely related to ethics are the responsibility areas of compliance and fraud. Some municipalities incorporated the responsibilities for compliance, fraud, and ethics under one heading while other municipalities addressed it separately.

Five of the six AC charters included AC responsibilities on fraud. These responsibilities include:

*Ensuring the fraud and corruption strategy and Code of Conduct are enforced and complied with (MUN1).*

*Ensure management ... is conducting its affairs ethically. This must include maintaining effective controls against conflict of interest, fraud, and corrupt practices. (MUN5)*

*Review the Council's policies for preventing and detecting fraud.*

*...Investigation into matters within its scope, for example, evaluation of the effectiveness of the Councils' internal control structure in respect of reviewing cases of employee and Councillor fraud, misconduct, or conflict of interest (MUN4).*

*Discuss any communication from management regarding their processes for identifying and responding to the risks of fraud in the entity.*

*Communicate with external auditor, any fraud, suspected fraud, or fraud investigation being conducted of which they are aware.*

*Discuss with the external auditor any concerns about the nature, extent, and frequency of management's assessment of the accounting and control systems in place to prevent and detect fraud.*

*Notify Council when the accounting officer has been implicated in fraud, corruption, or gross negligence; and*

*Confirm the establishment of a Disciplinary Committee responsible for the investigation of unauthorised, irregular, and fruitless and wasteful expenditure. (MUN7) and similar responsibilities at MUN5.*

Based on the various extracts from the charters, it appears that the extent of responsibilities related to fraud is not consistent between municipalities and could be indicative of another possible area for further research. A review of AC reports for additional information showed only two of the six AC reports referred to the AC activities on fraud, where the one report made reference to the Risk and anti-fraud and corruption committee and listed the policies reviewed by the Risk Committee. The other AC report indicated the AC advised on the Fraud prevention strategy and plan and reviewed the feed-back from the Risk and Fraud Committee.

Compliance responsibilities also varied between municipalities, although compliance was covered in all the charters reviewed.

MUN2 required the AC to review the effectiveness of the system for monitoring compliance and results of management investigations and follow-up of non-compliance. Further to review findings of any examinations by regulatory agencies and other auditor observations. The charter also provides for regular updates from management and the legal counsel on compliance matters.

MUN4 referred to responsibilities to include reviewing compliance with legislation and the council policies to ensure legal requirements are complied with. The municipality included the requirements as part of internal control in the charter and did not distinguish it by way of a separate section in the document contrary to other cases.

Under internal control environment at MUN6, the AC is required to review internal audit findings and follow-up of recommendations on compliance, monitor developments and changes in the law relating to the responsibility and accountability of management and review the extent to which management meets its obligations and ensure legal counsel regarding compliance where necessary. MUN1 and MUN5 includes similar requirements. MUN1 AC charter includes additional requirements in that the AC must review the arrangements management has in place to ensure compliance and provides that all amendments and additions to policy and statutory frameworks should be provided to the AC to enable them to fulfil their role.

The charter of MUN6 also requires of the AC to review policy documents that incorporate compliance with legislation and monitor the compliance with the policy. Additional



requirements at MUN5 include to ensure management has the necessary mechanisms in place to ensure compliance with pertinent laws and regulations, reviewing the effectiveness of systems for monitoring compliance and review if all regulatory compliance for the preparation of financial statements and performance management processes and reports have been considered.

MUN7 requires a review of the effectiveness of the monitoring system for compliance and the follow-up of any non-compliance. Further, the need to obtain internal and external reports on compliance with legal and regulatory requirements. Similar to MUN4, the requirements are included in the section on control environment without elevating it to a specific section in the AC charter. Only two of the six AC reports reviewed contained information on the AC responsibilities for compliance review.

Based on the analysis, it is evident that the AC would be very reliant on the municipality to provide the information to be able to execute the responsibilities on compliance. This together with the possible AC liability warrant further research in this area.

The CAE at MUN6 identified ethics and combined assurance as possible areas where the AC could give more attention. On combined assurance:

*So, I think we've taken combined assurance seriously, but it can be improved. So, what is actually the role the audit committee can take, on their level of defence, what role can they actually play, apart from doing oversight on the items that we have. That's something we need to look at, but there is a lot of work that still needs to be done.*

The CAE at MUN7 was of the view that the AC should pay more attention to compliance and combined assurance. All charters referred to combined assurance efforts, although not always in a separate section in the AC charter. Four of the six AC reports reviewed referred to the work done by the AC on combined assurance.

### **Fieldwork praxis tips**

- Include CA as a separate heading in agenda to ensure adequate attention.
- Consider the articulation of ethics responsibilities in AC charter for completeness.
- Be clear in AC charter what financial overview responsibilities are.
- Be specific in AC charter if audited/ unaudited FS should be reviewed.
  - Have separate sessions with managers for feed-back to AC.
  - Review PM responsibilities in AC charter for completeness.
- Clarity on role of AC in CAE appointments, removal and performance evaluations.

### Concluding observations – Roles and responsibilities

Most participants agreed that all areas of responsibilities including finances, internal control, internal and external audit, risk management, performance management, compliance, ethics, and combined assurance are important. Scrutiny of agendas and minutes of meetings also indicated coverage of all the areas of responsibilities. However, what emerged was that the focus of the AC is also determined by the specific risks and challenges at a municipality at a particular point in time and could consistently change as a result. Despite context-specific focus, transversal high focus areas also came to the fore during discussions. The most important being the role the AC plays in overseeing the financial process and financial information.

However, various participants expressed the need for ACs to become more involved with financial management at municipalities during the year and to provide advice and support on budgets and other financial decisions. A correlation between material unfavourable and unfavourable audit findings on financial health and the need for additional assistants with financial management expressed by the participants at the municipalities was observed. Role clarity in this regard needs to be further researched.

Another important role is the review of the internal control environment and work performed by the IAF. Charters comprehensively covered this responsibility. In practice, limited involvement of the AC took place in appointment, removal, and performance evaluations of CAEs.

Advising on performance management, being a legislative requirement, is another important area of responsibility for ACs in local government. Performance management has been identified as an area where AC members sometimes lack experience and expertise. The performance management responsibilities were also not completely covered in reviewed AC charters. The review of the AC reports on performance management also indicated different statements on the responsibilities and actions by the ACs. A strong plea from various participants is that service delivery rather than compliance should receive much more of a focus from the AC and in general. Performance management was also an area with negative audit findings at most of the municipalities that formed part of this research indicating the need for more focus and advice from ACs.

The area of risk management was identified as another important area for oversight and advice. At most of the cases, a separate risk committee is responsible for risk management with the AC playing more of an oversight and advisory role.

Although the responsibility of the AC related to IT governance is recognised the specific challenge is to recruit the necessary IT skills to form part of the composition of the ACs. To fill this gap consideration should be given to obtaining outside experts although cost containment measures might put a limitation to this. Negative audit outcomes at four of the seven municipalities were reported indicating the need for ACs to become more involved in this area. On the areas of ethics, fraud, and compliance, although some of the AC charters referred to it, the descriptions of the responsibilities between ACs differed considerably and it was considered to be areas where the ACs should be more involved with. The audit results also included negative findings on compliance at most of the municipalities in the study implicating that more attention to compliance should be given by ACs. However, the ACs would also be reliant on information from the municipality to be able to fulfil their responsibilities and warrants further research.

The discussion under the heading 'roles and responsibilities' reflected the view of the participants and document analysis on the responsibilities ACs focus on and should be giving more attention to. Under the next heading of 'Ceremonial versus substantive role' the view of the participants on the role the ACs play is further explored.

#### *7.4.3.2 Ceremonial versus substantive role*

One of the objectives of this research was to determine whether ACs provide substantive oversight or merely play a ceremonial role to create legitimacy. During the interviews, the ceremonial role versus substantive role ACs play were further explored. The majority of participants of this study related to the municipalities they are involved with overwhelmingly indicated the ACs play a substantive rather than a ceremonial role. Indicators of substantive rather than a ceremonial role were further demonstrated through the rigorous appointment process where AC members are appointed for experience and expertise and not because of a personal relationship. The regular and intensive formal and informal interactions, the important characteristics required of and demonstrated by AC members and chairpersons and the diligence are further indicators of a substantive rather than a ceremonial role ACs play. However, some of the participants shared experiences at other municipalities where it still appears that ACs are appointed merely to comply with the legislative requirements and the value ACs might bring, is not being fully utilised at the municipalities.

As could be expected all ACCs interviewed indicated the AC plays a substantive rather than a ceremonial role. A specific comment made by the MM at MUN6 clearly state management's expectation:

*Because we wanted to make sure that it's a committee that can contribute meaningfully as opposed to being a committee for compliance sake.*

Through discussions, it was confirmed the AC played a substantive rather than a ceremonial role. ACs endeavour to exercise effective and active monitoring and assistance rather than just serving as ceremonial ACs. The one ACC indicated he would immediately resign if his authority was restricted in any way. The same ACC was considering resigning from another AC he was serving on because management was not taking governance or the recommendations of the AC seriously. This also demonstrates AC members do not necessarily want to be associated with organisations with weak governance or management, due to the reputational damage and want to avoid situations where management wants the AC to merely fulfil a ceremonial role.

On the other hand, one of the participants acknowledged that due to the challenge in accessing knowledgeable local people with the necessary skills and experience, the municipality is sometimes forced to settle for an 'old school' member that will only check for spelling errors, to make sure the AC has the required number of members. The argument is as long as there are two out of the four members that are dedicated and experienced and contributes actively and adding value the municipality can accept the one or two members that do not really contribute. This could imply in some cases 'ceremonial appointments' still happen, to comply with the required minimum number of members but with the proviso that the majority of members on the committee play a substantive role.

According to research (Beasley et al, 2009), other indicators of substantive rather than ceremonial could include risk-driven agendas, significant involvement of the AC in determining the information to be included in the meeting pack and receiving the meeting information well in advance of the meeting. These indicators are further analysed under the heading 'Formal meetings'. Another indicator of a substantive role is the frequency of interaction in-between formal meetings addressed under the heading 'informal interactions'. Research also indicated the substantive role could further be demonstrated through the diligence in the oversight of the financial reporting processes and the internal audit function and active AC assessment of fraud risk and management integrity.

### Concluding observations – Ceremonial vs substantive role

The discussion results indicate a commitment to substantive monitoring and practices and praxis appear to be quite substantive. ACCs and participants in the cases of this research confirmed a substantive rather than ceremonial role ACs play. However, some participants confessed, due to the challenges in filling vacancies with skilled rural AC members on occasion ceremonial appointments for the minority of members would take place.

Other indicators of substantive rather than ceremonial role include the rigorous appointment process, intensive informal and formal interactions, characteristics such as strong personalities considered to be important by participants and diligence demonstrated by AC members.

The substantive monitoring role the ACs play is substantiated by the positive (green rating) AGSA findings on the ACs included in this study. At two of the municipalities the AGSA reported less favourable audit outcomes on the evaluation of the ACs. Incidentally for these two municipalities the overall audit outcomes were also less favourable with the one having an audit outcome of unqualified with findings and the other municipality a qualified with findings audit opinion.

Performance evaluations can be an important tool used to measure and demonstrate fulfilment of roles and responsibilities. Under the heading of 'Performance evaluations' the findings on the performance evaluations of AC members in practice are reflected on.

#### *7.4.3.3 Performance evaluations*

Evaluation of performance of ACs as a catalyst of effectiveness has been recognised in research (Martinov-Bennie et al, 2015:749). Furthermore, guidance for the performance evaluation of ACs in local government is provided in the King IV sector supplement on municipalities (IODSA, 2016) and circular 65 (National Treasury, 2012). These guiding documents recommend performance evaluation of its committees by the council to support continued improvement in performance and effectiveness (IODSA, 2016:84; National Treasury, 2012:9). Various forms of evaluation or performance assessment could be implemented including self-evaluation, assessment of compliance to the AC charter and assessing contributing performance of individual members. Contributing performance could include participation of AC members during meetings, value-added activities, and outcomes achieved.

The fieldwork has indicated various implementation practices for the evaluation of AC performance ranging from ad hoc evaluations, limited evaluations or absence of evaluations to satisfactory practices and have been identified by some participants as an area where a complete review needs to be done and recommendations made including who should be involved with the performance evaluations.

A review of the AC charters on the topic of performance evaluations were completed to obtain more information on the requirements for performance evaluations. The following provides a brief summary:

MUN1: The AC charter requires an annual performance evaluation against the charter by key stakeholders, including individual members' attendance and contribution. The AC charter also refers to periodic review of accomplishments against the charter and the submission of the reviews and evaluations to the council. Discussions with the MM and CAE confirmed that very honest annual evaluations are performed by the mayor and management as well as a self-assessment by the AC. A report of the assessment is provided to the AC, and any areas of non-performance are discussed. An example was given that at a time the ACC kept postponing the meetings that would have resulted in non-compliance to the charter. The mayor discussed this with the ACC and the situation improved.

MUN2: The charter requires that the committee's and individual members' performance should be evaluated regularly. At the municipality, the performance evaluation was done by the mayor and speaker.

At MUN4, the charter did not include a clause on performance assessment for the AC. The mayor indicated because the responsibility ends with him he likes to regularly 'scrutinise' the performance of all role-players by way of talking to people and observing the functioning to ensure up to standard because at the end of the day it is the taxpayers' money that is used to pay the AC for their services.

At MUN5 and MUN6, a detailed section on performance assessments (similar for both municipalities) is included in the charter. The AC is required to do a self-assessment of individual members with reference to the skills brought to the AC as a whole and to report the results to the MM and council. The charter also makes provision for required actions in case of non-performance. The mayor at MUN5 indicated he was not involved with any formal performance evaluation of the AC. However, due to the open relationship the mayor was of the opinion if they were unhappy with the performance of the AC, they would inform them.



At MUN6, the AC conducts a self-assessment, but it is not presented to council or MAYCO. The CAE recognised the process needs to be enhanced to include a feedback and discussion session around the performance evaluations of the AC. The ACC agrees that changes need to be made to include management and the CAE to form part of the assessment of the performance of the AC.

At MUN7, the charter requires a self-assessment against the charter as well as assessments performed by the MM and executive mayor. The ACC is required to present the findings to the MM and the mayor. It was confirmed there was a process of self-evaluation and third-party evaluations. Self-evaluation include regular comparison of actual work completed against the AC work plan that is prepared based on the required responsibilities listed in the AC charter as well as an annual evaluation.

Some criticism expressed against one of the ACs is not providing enough support to the IAF, time delays in taking up issues, ensuring consequence management is applied and the need for the AC to work as a collective. It is important for performance evaluations to be done that such matters can be identified and addressed to ensure maximum value added by the AC.

For both MUN5 and MUN7, the charter made the ACC responsible for acting in cases of non-performance and for the ACC to consult with the MM and mayor in this regard.

Another action that might be considered to form part of performance evaluations of AC is the annual evaluation done by the Western Cape Provincial Government on embedding good governance at municipalities, previously referred to as the Municipal Governance Review outlook (MGRO) and lately as Technical Integrated Municipal Engagements (TIME). This is a self-assessment tool completed by municipalities (mGap) and validated by provincial treasury on among other things, governance capability. At two of the municipalities, for example, reference was made to provincial treasury commented that the AC minutes were not detailed enough. The use and benefits of the tool falls outside the scope of this research but could form part of future research on the performance evaluation of ACs.

The Auditor-General, as part of the annual audit, also evaluates the extent to which the ACs fulfil their roles and responsibilities and reflects the findings in the management reports and in the AGSA annual general outcome reports (2017-18). In the 2017-18 AGSA general outcome report, no general negative findings on the ACs have been reported.

### **Fieldwork praxis tips**

- AC charter to include performance assessment and actions for non-performance.
- Performance evaluation process of Acs needs a thorough review.

### **Concluding observations – Performance evaluations of ACs**

Provision is made for the evaluation of the performance of ACs in some of the corporate governance guidance documents in South Africa. However, in practice it was observed different implementation practices, if any, were followed despite some criticism being raised against AC performance. The AGSA also reported unfavourable findings at two of the municipalities forming part of this study, which could possibly have been identified if adequate performance evaluations were conducted.

AC performance evaluations have been identified as an area that requires a complete review and overhaul.

Interactions, both formal and informal, between the AC and other role-players were studied to gain a better understanding of practices and praxis that affect AC effectiveness. The next two subsections portray the interactions between the AC and other role-players distinguishing between formal and informal interactions.

#### **7.4.4 Formal and informal interactions**

The research solicited the view and analysed information to be able to obtain an understanding of the formal and informal meetings and interactions between the AC and various role-players, including management, auditors, and council. Aspects include the number and duration of meetings, discussion points as per the agenda, the sufficiency of information before and during meetings, and the extent and form of informal interactions were covered. Information on both the ceremonial features and the substantive practices and praxis are analysed and presented in these two subsections.

#### 7.4.4.1 Formal meetings

Although a substantive role rather than a ceremonial role for ACs was confirmed at all the municipalities where discussions took place, some ceremonial features at meetings also play a role in constructing perceived AC effectiveness. Such features include the agenda and minutes as well as the formal feed-back provided by the AC. However, the substantive practices and praxis of formal interactions were also identified during the fieldwork and considered important. This section begins by reporting on the more ceremonial practices, including agenda-setting and content, distribution of meeting packs, and minutes of meetings. Information on the feedback from the AC to various role-players, including council, is addressed in subsection 7.4.5. The discussion on ceremonial features is followed by the substantive features of formal interaction in this subsection and informal interactions in the following subsection.

The discussions suggest that ceremonial features at AC meetings assist in creating the meaning of effectiveness. For example, two municipalities referred to the agendas being informed by the roles and responsibilities of the AC. Another ceremonial feature can be found in the content of agendas.

Table 7.10 below provides a summary of the topics covered on the agendas of the cases in this study.

**Table 7.10: Topics covered during audit committee meetings depicted on the agendas of the cases**

Topic	MUN1	MUN2	MUN4	MUN5	MUN6	MUN7
Financial information	√	√	√	√	√	√
AGSA information	√	√	√	√	√	√
IA - Progress on plan	√	√	√	√	√	√
IA reports	√	√	√	√	√	√
Report and documents on RM	√	x	√	√	√	√
Report on PI	√	√	√	√	N/A	√
IT	√	x	x	x	√	√
Combined assurance	x	x	x	x	√ IA report on CA	√
Follow-up IA reports	√	√	√	√	√	√
Follow-up AC recommendations	√	√	√	√	√	√

Based on the information in Table 7.10, it can be deduced that the agendas mostly reflect the roles and responsibilities of the AC included in the AC charters. The information in Table 7.10 also demonstrates the focus of the ACs on areas of financial information, attention to reports by the AGSA and follow-up on findings, review of internal audit activities, reports and progress of internal audit plans, risk management, and performance information. According to the agendas and minutes reviewed, these focus areas are aligned to the important responsibilities as viewed by participants and discussed under the heading 'Roles and responsibilities'. Some of the cases included more detailed sub-focus areas in the agendas and minutes; for example, financial information would consist of UIFW expenditure, cash flow, compliance, and budgets. In addition, sub-focus areas under risk management include fraud and feed-back from the disciplinary committee. The ceremonial features in the agendas will ensure consistency over time and enable an almost automatic planning of the content whereby attendees know what to expect.

Based on the researcher's own experience and observed during the attendance at AC meetings, there are continuous efforts by ACs to improve and expand items on the agenda and minutes. The researcher believe that it is informed by members serving on various AC and comparing the features of the agendas with best practices noted at other municipalities while serving on those ACs.

Other ceremonial practices include distribution of meeting packs, minutes of meetings, preparation of agenda, and invitees to the meeting. These are further analysed in Table 7.11, which provides information on further documentary and logistical features of a typical AC meeting at the cases in this research.

The ACC at MUN6 indicated the meeting dates are structured around reporting dates. Management is required to provide information within three weeks after the end of the quarter to enable timely feedback to the council. Although it puts management under pressure, it is a necessary arrangement.

At all the municipalities, the IAF and specifically the CAE acted as co-ordinator and facilitator for the compilation of the AC meeting documentation.

Another different practice/praxis at the municipalities are the attendees invited to meetings, as indicated in Table 7.11. At MUN1 and MUN2, the AC meetings were also attended by the chairpersons of the Risk Committee and MPAC. The CAE at MUN2 mentioned explicitly the purpose of the invitation to the member of MPAC is to capacitate council. However, at MUN4

and MUN6 no council members are invited to the meeting. This to prevent any political interference as explained by the ACC. However, this does not mean no or limited contact or information sharing. The ACC meets with the mayor at MUN4 after every formal AC meeting to provide feedback. At both MUN4 and MUN6 the ACC meets with MAYCO once a year where detailed feedback is provided without management being present.

During the fieldwork discussions, no major criticism against logistical features of AC meetings was raised. The only possible negative comments were that meetings were sometimes too long and the agenda very full or overloaded. However, in light of cost containment measures implemented by most municipalities the reasons for this are apparent.

Table 7.11 reflects some of the documentary and logistical arrangements of meetings at the different cases, although it did not form a high priority during the free-flow discussions with the participants.

One important praxis of proceedings associated with formal interactions identified were the pre-meeting sessions between the AC and the IAF, without management being present, prior to the formal AC meetings. The pre-meeting sessions also indicate substance rather than a ceremonial role for ACs. These pre-meeting sessions occur at all the municipalities in the research and the benefits of these pre-meeting sessions were recognised throughout.

The purpose of these pre-meeting sessions was explained to provide internal audit with a safe environment where they can raise issues with ACs without management being present or indicate areas in which they need assistance and support. It also provides internal audit the opportunity to bring any pressing issues to the attention of the AC. Important matters that need to be included during the discussions at the pre-meeting sessions were identified to include, for example, the cases where the IAF was struggling to get management comments.

The CAE at MUN6 felt strongly about the importance of informal interactions including the pre-meeting sessions with the AC and explained the purpose:

*It's important. I think the informal is much more important [than formal]. In fact, one of my agenda items you will see is also in-camera discussions between CAE and the audit committee before we commence the audit committee meeting. Purely to share ideas about the things that concerns me, maybe on responses or on things that will happen, so that they are aware when it comes to that item they can do a bit more robust discussion. So good communication.*

**Table 7.11: Summary of documentary and logistical features of a typical audit committee meeting**

	<b>MUN1</b>	<b>MUN2</b>	<b>MUN4</b>	<b>MUN5</b>	<b>MUN6</b>	<b>MUN7</b>
Agenda preparation	Prepared by CAE, approved by ACC and signed off by MM. Management and ACC have inputs into agenda	Prepared by CAE in consultation with ACC	Informed by AC	Prepared in consultation with ACC. Any additional items have to be presented 2 days prior to meeting.	Prepared by CAE in consultation with ACC	Prepared by CAE, provide for items to be added by ACC or AC members before the meeting
Information sent in advance of meeting	7 days	5 working days	7 days	7 days	7 days	Minimum 7 days
Duration of meetings	Up to 5 hours including pre-meeting	Up to 5 hours including pre-meeting	Depends but time strictly managed by ACC	As long as required between 3 and 4 hours	Depends but time strictly managed by ACC	On average 3 hours
Invitees – AC charter	MM, CFO, Directors and Deputy directors, CAE, Chief Risk Officer, invitee from MPAC, AGSA, PT, SALGA, and any other invitees	Senior managers and other invitee considered necessary including MPAC chair and Risk committee chair	MM, CAE, Chief Risk Officer, CFO, Directors, Performance Manager, and other invitees	Mayor, Chairperson of Finance portfolio Committee, MM, CFO, Director Management Services, CAE, and IA officials.	MM, CAE, Chief Risk Officer, CFO, Directors, Performance Manager, and other invitees	Mayor, Chair of Finance Portfolio Committee, MM, CFO, Manager Strategic Services, CAE, Risk officer any other invitees

The MM at MUN4 considers the pre-meeting sessions to be valuable. He explains that it also serves as an early warning system for him to get additional documents and explanations ready prior to the meeting.

*[The CAE] will meet them at 8.30, the meeting is at 10 and then they will say we need more of this, less of that, we need more of this sort of thing. Which is great. ..., we've got a little bit of an early warning which I think is another proactive practice. It cuts down the surprises.*

### **Fieldwork praxis tips**

- Allocate work for inputs during meeting to members according to areas of speciality.
- Disclose meeting attendance per AC member in AC report.
- Ensure adequate number of meetings to fulfil all key areas of responsibility.

### **Concluding observations – Formal interactions**

Regular formal AC meetings take place and are preceded by a pre-meeting sessions between the IAF or CAE and the AC without management being present. This provides an opportunity for the IAF to raise matters that they would like to bring to the attention of the AC prior to the meeting or to identify areas in which they need support. The pre-meeting sessions have proven to be beneficial. Agendas used during the meetings cover mostly the roles and responsibilities of the AC as set out in the AC charters. ACs focus on financial information, AGSA findings and follow-up, review of internal audit progress against the plan and reports, risk management, and performance management. In general, satisfaction was expressed on logistical features of AC meetings except for sometimes being too long and agendas being overloaded. As far as could be established, the AGSA also did not report any negative findings at most of the municipalities on the logistical arrangements of the audit committee confirming the soundness of the practices implemented. Various practices and praxis on AC performance evaluations or lack thereof were identified and has been highlighted as an area that requires a complete review and overhaul.



#### 7.4.4.2 Informal interactions

Research on AC effectiveness has supported informal interactions and found various positive associations between the prevalence of informal interactions and other factors, discussed in Chapter 2. Both the culture of the organisation that encourages informal interactions and the role of the ACC positively influence the extent and benefits of informal interactions.

This research has found regular communication between the AC and other role-players, including the CAE, MM, and members of council, takes place outside the formal meetings. Most participants believed that informal interactions are important and contribute significantly to AC effectiveness.

The need for regular informal interactions between the ACC or AC members and the mayor were expressed by the MM and CAE at MUN1, because it helps to build relationships and assists with the buy-in by management on the implementation of recommendations (CAE-MUN1).

The MMs at MUN1 and MUN6 welcome informal interactions over and above the formal scheduled meetings. The mayor at MUN1 also referred to informal interactions between the ACC and the mayor. The CAE at MUN1 confirmed that informal interactions between the AC and/or ACC, the mayor, MM, and managers take place as and when required. After each AC meeting the ACC would meet with the MM and the mayor. In some cases, the whole AC would meet with the MM, for example, during the external audit process.

The MM at MUN2 also confirmed regular informal interactions on request or not and the value obtained from those interactions.

The MM at MUN4 confirmed regular informal interactions:

*It's not that we just have contact with them on the day we come to the meeting. Fortuitously I'm sitting here, and I've had two engagements with the chairman. Right here as you're sitting here, so it's not, that I don't see them again until the next meeting. He keeps that link going. It's a two-way process.*

The CFO also confirmed having regular communication and interaction with the ACC especially during the audit process but also during the year if required. The CFO expressed the view that a relationship between the CFO and ACC should exist that is free and frank.

An interesting observation was that for some municipalities the informal interactions and the AC getting involved in functional matters are seen to be beneficial while at other municipalities it is considered to possible over-step the fine line between advising and interfering. The mayor and MM at MUN5 indicated they did not consider a need for informal interactions. At MUN5, the MM believed that there was no need for off-the-record discussions because of the open administration approach where all items are discussed openly during AC meetings. According to the MM and mayor, when required there is informal interaction after the meeting but that happens to a limited extent. This was confirmed by the ACC. At the same municipality, however, the CAE indicated he is able to engage with the AC any time before the meeting.

The mayor at one of the other municipalities also did not consider informal interactions other than scheduled meetings to be necessary if a good and open relationship exists. He indicated one should be careful as having too many informal interactions could result in that fine line between advising and becoming involved with management being crossed. He acknowledges that informal interactions could be required if a good working relationship does not exist. At the same municipality, the CFO concurred and considered informal interactions unnecessary due to good interaction and information to enable decision-making and being able to provide advice.

Research on ACs also recognises the importance of relationships between the AC, management, and the auditors and the extent to which it improves the quality of governance processes. In South Africa, in circular 65, the importance of engagement between the mayor, MM, and the AC and internal audit are also recognised (National Treasury, 2012:1).

The review of the AC reports also indicated the importance of the relationships between the AC and different role-players. Some extracts in this regard include:

‘The [audit committee] enjoyed a good working relationship with the Municipal Manager and Directors as well as the Executive Mayor and councillors that attended meetings of the committee’.

‘The committee would like to express its satisfaction on the following issues: ... Support given by the Mayor, Council and the Municipal Manager as well as the level of communication between the parties.’

### Concluding observations – Informal interactions

Mixed views on the importance of informal interactions between the AC and/or ACC and other role-players including the mayor, councillors, management, and internal audit were expressed by participants. On the one hand, informal interactions were considered important to build relationships and provide continuous support, while on the other hand, the danger of informal interactions result in the fine line between advice and interfere being crossed.

The different approaches and views on informal interactions did not seem to have an effect on the AGSA audit outcomes and findings.

The AC needs to demonstrate the extent to which roles and responsibilities have been fulfilled. The next subsection presents communication practices and praxis by ACs including the AC reports included in the annual report being a public document.

#### 7.4.5 Audit committee communication including reporting

This subsection covers the perception of the usefulness and adequacy of communication between the AC and ACC and other governance role-players. It further provides an analysis of information reported in the AC reports and included in the annual reports of the cases forming part of this research. Communication for this research includes both oral and written communication.

Chapter 4, based on other research, alluded to the importance of and the need to enhance AC reports based on the extensive AC responsibilities. It also identified the need for AC reports to create confidence in the work performed by the AC and the power of AC reports to educate and demonstrate effectiveness. Chapter 4 also presented the King IV requirements for the AC report, including reporting on significant matters related to AFS and how the AC addressed those. The King IV further requires of the AC to report its view on the quality of the external audit, the CAE and internal audit arrangements, combined assurance, the CFO and finance function, the effectiveness of internal financial controls, and the nature and extent of significant weaknesses that resulted in material financial loss, fraud, corruption or error.

In local government legislation, the only reference related to information sharing is contained in the MFMA, section 121(3)(i) and 121(4) that requires the annual report of the municipality to include any recommendations of the AC (RSA, 2003).

The most recent AC reports in the annual reports were reviewed to elicit information on areas covered in the AC reports, and the results are reflected in Table 7.12. The annual reports of the cases were also reviewed to establish the extent to which AC recommendations are included in the annual reports. The most recent AGSA audit reports for the cases were also scrutinised for matters relating to the AC and to establish consistency between matters raised by the AGSA and the AC.

As part of the AC, one municipality report includes paragraphs on the advisory role to the council and the MM and staff. An interesting praxis at one of the municipalities is to include a list of areas of satisfaction as well as a list of areas of concern as part of the AC report. Two of the municipalities included a list of the IA reports reviewed as part of the AC report.

Based on the analysis of the content of the AC reports included in Table 7.12, several observations can be made. The analysis revealed that the scope and content of the information provided in the different AC reports vary significantly. A positive feature of all, but one municipality, is that in the reports, the AC states that they have complied with the legislative requirements, terms of reference, or both. In line with expectations, indicated as the most important area of responsibilities for ACs identified by participants, the AC reports included information on the review of AFS. All but one municipality stated that the AC reviewed and made recommendations on the AFS before submission to the AGSA. The exception indicated review before submission to the council. One of the municipalities included the details of the different focus areas as part of the review of the AFS.

The other important area identified by the participants covered in the AC report is the role related to the AGSA. At most of the municipalities, the AC report referred to the review of the AGSA audit report, and some ACs also referred to the review of the implementation of recommendations. Interestingly, only two reports stated that the AC concurs with the AGSA findings and recommended that it is accepted. A possible reason for not including such a statement is that the AC merely plays an advisory role and does not have the authority to recommend acceptance of the AGSA report.

**Table 7.12: Areas covered in audit committee reports of cases**

83	MUNA	MUNB	MUNC	MUND	MUNE	MUNF
AC report heading	Report of the independent performance and audit committee for the year ended.	Report of the audit committee for the year ended.	Refer to oversight report.	Refer to oversight report.	Audit Committee Report for the financial year.	Annual Report of the Audit and Performance Committee.
Reference to independence	Title of report indicates independence and the composition statement.	Refer to the independent role and state the AC does not assume management functions.	State AC is an independent committee.	No reference.	No reference.	Refer to MFMA requirements but do not state compliance.
Membership	Include member names, meeting dates and attendance, qualifications of members and tenure period.	Names of members, meeting dates and attendance.	Include members' names and the number of meetings held.	Include members' names and the number of meetings and reasons for meetings.	Include members' names, number of meetings held and attendance per member.	Include members' names, number of meetings held and attendance per member.
Confirm compliance to Charter	Statement on compliance with terms of reference and legislative requirements.	Statement that confirms compliance with legislative requirements and terms of reference.	Statement that complied with legislative responsibilities and charter.	Statement that complied with legislative responsibilities.	Statement that complied with responsibilities as far as practically possible and that it has performed its responsibilities in line with the charter.	State AC adopted its terms of reference.
Statement on Evaluation of AFS	AFS reviewed and recommendations made to management as part of an advisory role.	Evaluate and advise on draft AFS, ensuring compliance with GRAP. Reviewed accounting policies.	Refer to correction by the municipality of misstatements and that AC will continue to monitor IC related to AFS preparation to reduce the risk of misstatements.	Review draft AFS, financial reports and quarterly reports.	Reviewed AFS before submission to AGSA.	Reviewed the AFS before submission to AGSA. Include focus areas of AFS review. Include a further statement on the review of audited

<sup>83</sup> The numbering allocated to municipalities differs from that used in the rest of the thesis to maintain confidentiality, in that the audit committee reports are public documents.

83	MUNA	MUNB	MUNC	MUND	MUNE	MUNF
						AFS before inclusion in AR.
AGSA	Activities recorded: - Review, discussed AGSA terms of engagement, plan, and budget. - Review and discussed the draft report and management letter.	Reviewed AGSA audit report on AFS and compliance with laws and regulations. Reviewed implementation of recommendations.	Reviewed AGSA audit report and commended municipality on positive outcomes.	Comment that AGSA issued the Audit report and management letter at a specific date.	Implementation of recommendations monitored by AC.	Include statement that concur with conclusions of AGSA and recommend acceptance.
Statement on the effectiveness of IC	List functions completed in terms of IC. Refer to AGSA conclusion on the control environment. List the recommendations made by AGSA to improve control. Statement that corrective actions are monitored.	Statement that evaluate and advise on the effectiveness of IC and in-year monitoring.	No specific comment.	Refer to the assurance provided by IA.	Refer to the monitor of the action plan to address control weaknesses reported by AGSA.	Concluded on internal control effectiveness.
Internal audit	List activities executed in respect of IA including review of Plan. Evaluate independence and effectiveness. Review work of IA on a quarterly basis and	State: Reviewed progress with the implementation of recommendations. Also reviewed IA reports, plan, progress with the	List IA reports. Refer to quality assurance performed and the monitor of improvements.	List IA engagements reviewed. Stated approved internal audit plan.	Made statement on the effectiveness of IAF. Also referred to the AC enforcing implementation of internal audit recommendations.	Comment on the effectiveness of IAF. List IA documents approved. List internal audit reports presented to the AC.

83	MUNA	MUNB	MUNC	MUND	MUNE	MUNF
	implementation of recommendations.	plan, independence and objectivity, capacity of IA, annual assessment of IAF, annual review of charter.			Statement on monitoring of pre-approved internal audit plan.	
Performance management	Describe the work the AC does related to PM, refer to AGSA opinion on performance information and refer to monitoring management's actions.	Statement that: Review quarterly performance reports. Review performance management system and report to the council. Assessment of objectives and achievement.	Statement based on work performed by AGSA and IAF satisfied with performance management processes and reporting adequate. Refer to AGSA audit opinion on performance information.	Refer to IA work and performance evaluations of s56/57 employees. AC attended to performance assessments of MM and Director, mid-year performance assessment reports.	Refer to work performed by the IAF on performance information.	Statement the performance information was reviewed and commented on regress in performance. Statement on the review of the annual performance report and quarterly reports.
Risk management	Describe progress and risk management processes and states the AC exercise the advisory and oversight function.	Statement concerning evaluation and advice on RM processes through minutes and feedback from Risk committee, including fraud and emerging risks. Reviewed RM framework and analysis of results of risk assessments.	Included paragraph on risk management and the AC will continue to monitor.	Statement that attended to: Quarterly RM committee meeting minutes, progress reports on risk management.	Describe the risk management process and states it forms the basis of the internal audit plan.	Describe the municipalities risk management activities.



83	MUNA	MUNB	MUNC	MUND	MUNE	MUNF
		Reviewed RM plans and fraud prevention strategy and plan.				
Combined assurance	Refer to the development of combined assurance framework and monitoring by AC.	Statement that evaluate and advise on the combined assurance framework and model. Review co-ordination with EA to eliminate duplication.	-	Statement that attended to progress reports.	-	-
ICT	-	Statement that evaluate and advise on the ICT function	-	-	-	-

On the effectiveness of internal control, only one AC report stated whether the internal controls are effective or not. The other AC reports referred to the work done or results of work done by the AGSA and the IAF and their conclusion or opinion on the internal control environment and stated the AC review and monitor implementation of recommendations. Closely related to internal control is the work performed by the IAF and five of the six AC reports reviewed referred to work performed by the AC related to the internal audit plan, two of the six referred to following up on internal audit recommendations. At the same time the third AC stated that they enforce recommendations. One AC stated specifically that they also review the capacity of internal audit. Three of the six AC reports listed the different internal audits/projects for the year and a question can be raised if this should form part of the AC report or whether it could be included in another part of the AR that describes the role of the IAF. The other important areas of risk management and performance management are also covered in all AC reports, although the content differs significantly. On risk management, the information in the AC reports appears to describe to a certain extent the risk management processes at the municipality rather than the work performed by the AC in this regard. For example, statements like the AC 'attended to' are made. Risk management and performance management were identified as some of the areas where the AC should become more involved with, and the extent to which it is covered in the AC reports might be indicative of these perceived areas where ACs are lacking. The same statement can be made about combined assurance where only three of the six AC reports included very cryptic comments and ICT where only one of the six reports included a statement. Both ICT and combined assurance were also indicated as areas where more focus by ACs is required.

Another possible shortcoming in current AC reports is the extent to which ACs disclose their view on the effectiveness of the finance function, as required in King IV. None of the AC reports reviewed referred to this.

Other areas not adequately covered in AC reports identified through analysis include the work performed by the AC on in-year reports (only two of six ACs reported), ethics (no ACs reported), fraud (only two ACs reported), IT (only one AC reported), and compliance (only two ACs reported).

However, when these various possible shortcomings are considered, it is of utmost importance to consider the mandate of the AC as well as the reader or user of the public document being the Annual Report. Considering that the legislative mandate is to advise council and management, an assumption is that more detail of work performed, and assessment opinions and recommendations might be reflected in the in-year reports submitted to council and

management. In contrast, the publicly available AC report included in the annual report might be a more sanitised version, especially in light of possible liability implications.

On the topic of the possibility of more detailed information reported in in-year reports to council and management, further analysis was required. Circular 65 recommends the quarterly report to council should include information on the activities of the AC and a summary of IA work performed against the respective annual work plans. It further recommends that the report include information on the effectiveness of internal controls and additional measures implemented to address risks, key issues the AC dealt with, and progress with any investigations and the outcomes (National Treasury, 2019b).

The researcher did not have access to all the AC minutes and reports to council so was reliant on the requirements in the AC charters and views expressed by participants over and above the publicly-available AC reports. The most recent AGSA audit reports for the cases were also scrutinised to identify any findings on ACs or other matters that one would expect to be addressed in the AC reports.

An example of the reporting requirements of the AC contained in one of the AC charters includes the following:

The chairperson of the [AC] will prepare a report on the operations of the Internal Audit unit and the [AC] and will submit its report to the ... Municipal Council on a quarterly basis. The reporting should include a summary of the work performed by Internal Audit and the [AC] against the annual work plan, issues, and related recommendations. Other reporting responsibilities include:

- 3.7.1 report to the ... Municipal Council about the [AC's] activities, issues and related recommendations when deemed appropriate.
- 3.7.2 provide an open avenue of communication between Internal Audit, the external auditors, and the ... Municipal Council.
- 3.7.3 review any other reports and issues related to the [AC] responsibilities.
- 3.7.4 report annually in the Annual Report, describing the committee's composition, the effectiveness of internal controls, comment on its evaluation of the annual financial statements and confirming that all responsibilities outlined in this charter have been carried out.

The [AC] may forward specific [AC] meeting minutes and reports to the Municipal Council. Any material findings shall immediately be reported to the Accounting Officer, the Auditor-General and the Executive Mayor and where appropriate the [AC] may also report to other authorities.

The practices and views of participants on AC communication were also solicited during the discussions. Various communication practices are followed.

At MUN1, an AC report is tabled at the council and the full AC attends the meeting to answer questions. It is the only case in this research where the full AC attends the council meeting when the report is tabled.

At MUN2, one of the members of the AC attends the council meeting where the minutes and recommendations of the AC are presented, if invited by council.

At MUN4, the MM explained a positive two-way communication between the AC and the council. The council and MAYCO receive minutes of the AC meetings and the ACC can attend a council meeting whenever the chair expresses the need. The AC also receives copies of the minutes of council meetings so are kept up-to-date with any developments and decisions at the municipality. The AC report twice a year to MAYCO that takes the ACC report to council.

The mayor at MUN4 confirmed the value brought by the communication:

*[I think it [communication] is complete and definitely not one-sided, it is honest information that we get and positive criticism and that is why I think it is very important for the audit committee chair to be a-political. The audit committee chair should be able to walk-in and give an opinion, a strong opinion, and not just what the municipality wants to hear, otherwise what is the purpose? It is very important for me that he gives an honest opinion and express criticism and provide recommendations in the process. For example, in the case of ICT, it was a problem for us, the AC picked it up and spoke to us about it. And yes, it was also a problem for us, but it was just much clearer and more prevalent when they informed us.]*

At MUN5, the ACC prepares the AC report, but it is presented to council by the CAE. Again, the arrangement could be to save costs but prevents the council from asking questions to the ACC. However, at the municipality the CAE stated council merely 'notes' the AC reports and the mayor attends every AC meeting. The ACC at MUN5 emphasised the importance of the AC speaking 'as a whole'. He referred to an incident at another municipality he is involved with where the ACC communicates without consulting the AC. Then at the meeting the AC will differ among themselves, which is not an ideal situation.

One of the ACCs suggests the development and use of a standard report/template similar to what you find in other professions, for example, the audit report that could demonstrate

professionalism in the 'AC profession'. The ACC indicates their AC reports have been expanded to include what works well, the concerns, and the challenges. However, the ACC emphasised that a written report is not enough and should be complemented by providing verbal feedback. This was considered necessary if the AC wanted to influence decision-making. His views were also shared by the mayor at MUN7, who stated that only receiving the minutes and the AC report is not sufficient as it is too long and not read by the councillors. He suggested a shorter version with the title, issues, recommendations, and solutions. The MM at the municipality confirmed the view and suggested a dashboard while the CAE believed the report had to be more precise on what transpired, what needs attention, and what gets addressed. At MUN5, a short summary together with the AC minutes, are submitted to the council. The ACC believed that the narrative was necessary and criticised municipalities where only AC minutes are submitted to the council. The MM at the same municipality warned against the AC report being an 'overkill'.

At MUN6, the CFO was very complimentary about the AC report and the interactions on the AC report:

*I think it's very much important to have a report like that and normally in that report the audit committee will make specific recommendations to council. ... the chairperson of the audit committee will also have the opportunity in the council meeting to submit the report to them to provide explanations to them. It's just not a matter you submit the report and council note the report, and it's gone. He normally, the chairperson, normally then engages council in that, and then he will give reasons, elaborate on some of the issues and the recommendations made and then normally the council take note of that, and then it becomes an issue to the municipality – to say, but this is what we want to see, this is where, it's an improvement and to make sure that we deliver.*

At MUN7, the minutes of the AC meeting are submitted to the Executive Committee and after that to the council. The MM suggested the AC should consider adding a dashboard but needs to consider carefully what information is included to make sure value is added.

The review of the information on ACs in the annual report also revealed different practices and praxis among municipalities.

The annual report of MUN1 contained a summary of AC resolutions and recommendations indicating the total number of resolutions/recommendations launched, implemented, and outstanding. The annual report further provides details of the specific resolutions or recommendations made by the AC per meeting covering a wide variety of areas. For example,

recommending an assessment of the internal control environment with regards to the safeguarding of assets and present an assessment report at the next AC meeting and checking duplicate creditors and bank accounts.

MUN2's annual report contained detailed AC recommendations per directorate and sub-directorate and appeared to be informed by the detailed internal audit reports.

At MUN4, the list of recommendations was included in the annual report but merely listed the areas on which recommendations were made, referring mostly to internal audit reports.

At MUN5, the list of recommendations included in the annual report also referred to the different areas reviewed by the AC and recommendations referred mostly to 'take cognisance of' or 'noted the content of reports'.

MUN6 also included a list of recommendations by the AC.

Additional possible areas of reporting and or improvements of AC reports include adding a statement on the effectiveness/non-effectiveness of internal controls, including specific information where the work planned by internal audit could not be completed, and where appropriate the possible impact of this on the municipality. Potential areas for inclusion in the AC reports suggested by Roos (2017:142-143) include additional information on the processes and work performed by the AC related to risk management, accounting policies, performance management, governance, AFS, significant accounting and auditing issues raised by internal audit and the AGSA and the extent to which it has been addressed, compliance management, performance evaluation, combined assurance, going concern, integrated reporting and ethics management. The extent to which this should be reported as part of the annual report, being a public document, or as part of quarterly reporting to council and management needs to be researched further, especially in light of AC liability concerns.

Although participants continuously expressed the value added by AC during the discussions as a concluding discussion point, the researcher solicited the views on additional matters that could improve AC effectiveness. The next subsection presents the responses.

## **Fieldwork praxis tips**

### **Include in AC report:**

- Independence statement of AC;
- Qualifications of AC members;
- Statement on effectiveness of IC;
- Statement on capacity of IAF;
- Statement on effectiveness of finance function;
- AC work performed on performance management, risk management, in-year reports, ethics, fraud, IT and compliance;
- Present in-year AC information to council in a user-friendly format including visual tools, dashboards and other means.



### **Concluding observations – AC communication and reporting**

AC reports can serve various purposes over and above, demonstrating accountability including creating confidence and serve as an educational tool. The analysis of the content of the AC reports included as part of the annual report indicated significant differences in the scope and content of AC reports. The analysis further revealed a disjuncture between the extensive roles and responsibilities of the AC and the demonstration thereof in the content of the AC reports thereby possibly negating the potential benefits.

Various improvements in the content of the AC reports are suggested and included in the recommendations of the study subjected to further research, including the possible impact on AC liability. Specific areas that are covered to a limited extent in AC reports include the work performed by the AC on risk management and performance management. Other areas on which limited, or no information is provided include in-year reporting, ethics, fraud, IT, and compliance. The limitation is that the analysis is performed on the public available document, being the annual report and not the quarterly reports that are presented to the council.

Different praxis are also followed by ACs regarding the information and how it is presented to governance role-players. Suggestions for improvement of this have also been put forward by participants. The findings of the research that the extent of work by the AC on IT, performance management and compliance should be improved seems to be supported by the negative AGSA audit findings on these areas at the municipalities forming part of this study.

#### **7.4.6 Overall perceived effectiveness of audit committees**

This subsection concludes the overall perceived effectiveness of ACs by the different stakeholders and to determine whether a gap exists between what is required of ACs in terms of legislation and best practice and the expectations of stakeholders. The participants were also encouraged to identify any additional matters, other than already mentioned, that could improve the effectiveness of ACs.

As the researcher concluded each interview, the researcher asked participants if the ACs are effective and add value and the response by participants was overwhelmingly positive. The general overall impression that emerged from the discussions and demonstrated by some of the quotes included throughout this chapter demonstrates that AC members generally apply themselves seriously to make the committee effective and add value to municipalities.

Table 7.13 reflects a high-level summary of the gap analysis between the determinants of effective ACs informed by legislative requirements and best practices and the experiences shared by participants.

Some additional individual positive comments expressed by participants include the following.

At MUN1, the MM recognised the decisive role the AC played in the improvement of audit outcomes and the support when there are disagreements with AGSA. However, he stated the effectiveness of the AC is determined by the effectiveness of administration and council and the relationship between the different parties. The AC's positive role was also recognised by the mayor, who indicated they are very satisfied with the value the AC adds to the council.

At MUN2, both the representative of the council, the MM and CAE praised the contribution of the AC in reforming the municipality in terms of audit outcomes. The CAE stated everyone, including senior management and the council, realises the benefits of having an AC.

The statement by the MM at MUN2:

*You must remember this municipality comes from a situation where we, a couple of years ago, we were in a very bad state. And the audit committee was part of the change management strategy. ... So, they have been engaging, turning this municipality around into a more acceptable organisation from a governance point of view.*

At MUN3, both the mayor and MM expressed their satisfaction with the contribution made by the AC, especially in the area of finance.

At MUN4, all the role-players were very complimentary about the AC and especially the ACC. The MM expressed his view on the value added by the AC:

*And then always what I find challenging, it's not just the sterile agenda. If I pulled out any of mine, you will see at least 5 – 6 items that they will add on the day of the meeting. We welcome that. You know what, they're all relevant and I think the right word there is transversal.*

At MUN4, the mayor valued the positive, honest criticism received from the AC. He re-emphasised his view that the most value is added through the honest, sincere opinions that he considered to be even more important than the competence of the AC.

**Table 7.13: High-level gap analysis between effectiveness determinants and participant experiences**

Determinants	Experiences of participants
AC experience and expertise	Experience and expertise of the majority of AC members were considered to be sufficient and highly valued especially at the smaller, rural municipalities that do not necessarily have all the required expertise in-house. Participants viewed the ACs' contribution to positive audit outcomes to be one of the key value-adding elements which is linked to the experience and expertise of AC members, especially financial expertise. The research indicated additional areas where expertise are required, include IT and performance management.
AC composition and independence	<p>Despite the view that ACs have the necessary experience and expertise, throughout the research the most significant and prevalent challenge identified is the difficulty to attract the required skills and experience of members to serve on the AC, especially at rural municipalities. Possible reasons put forward include the low remuneration and potential reputational damage in getting involved in municipalities with poor governance. This may result in head-hunting, including calling upon previous contacts and acquaintances to serve, which could result in the independence of the AC being questioned. However, the research has shown mitigating actions to address the risk.</p> <p>AC members also serve because they have a vested interest in the municipal area or as part of their social responsibility. However, the sustainability of this as a reason to serve is questionable.</p>
AC power and authority	<p>The power and authority of the AC is obtained through the AC charter, which in all cases seem to cover most of the roles and responsibilities of the AC required in legislation and best practice. The AC charter also allows ACs unrestricted access to information and people.</p> <p>Power is also found through the culture of the municipality, including visible support to the AC by the council, management, IAF and external audit. From the ACC perspective and those of other governance role-players, adequate support is provided to enable the AC to fulfil their responsibilities. Authority is further demonstrated by the extent to which AC advice and recommendations are valued and implemented.</p>
Working relationships	<p>Participants attested to open, honest, and good working relationships between the AC and other role-players that are considered to be important to build trust. Formal and informal interactions can play an important role in building these relationships.</p> <p>Communication and communication style from the AC also featured as an important factor. Communication to the council was identified as an area that needs attention from ACs.</p> <p>Another area identified that should receive more attention is the working relationship between the AGSA and other role-players, including ACs.</p>
AC resources	Resources are sufficient to support the AC and include having the support from the other governance role-players, a sufficient number of AC members, unrestricted access to management, council, and auditors through formal and informal interactions and to timely and complete information.
AC diligence	The diligence of ACs was demonstrated through attendance, preparation, and participation at meetings. One element identified that could impact on acquiring the necessary skills and experience and on AC diligence is the current level of prescribed remuneration. Diligence can also be affected by the time availability of AC members influenced by other professional responsibilities and serving on multiple ACs or boards. Mixed views on AC remuneration and serving on multiple ACs were expressed.
AC characteristics	Participants identified important characteristics of AC members to display a strong personality and actions together with honesty and integrity in fulfilling their responsibilities. In the demonstration of a strong personality, interrogation through challenging, context-based questions and dealing with the issues constructively was considered to be important, together with independence and objectivity. Other characteristics identified include leadership, not being easily influenced, and understanding the local government environment.
Role of ACC	The role of the ACC was identified as critical in constructing AC effectiveness.

The MM at MUN5 appreciated the AC playing an extra assurance provider role and being independent. The mayor recognised the important role the AC play in assisting in the municipality's dealings with the AGSA, including discussions about the audit fees.

At MUN6:

*...we have competent people, who have an understanding what is happening with local government and I think definitely from my side looking now what the legislation actually expect*

*of us, and expect from the audit committee what they need to deliver on to add value, and why there's so much emphasis on that, I think in our instance we can say there's definitely value added to the municipality. And even the communication to the internal auditor, the way it's been communicated to them and also filter through our management meetings. I would definitely say from my view, definitely that they add value. You know, in the past and I'm now CFO for more than 16 years actually, you never had that kind of support. Normally you will be man alone and if everything is fine, then everybody receives the accolades, but when something goes wrong then it's the CFO the MM. So in our instance what is nice about it, it's been communicated to us and then definitely if it makes sense, and normally it does make sense, that we make sure somehow in our processes that we added it in, to make sure if we can learn, we learn every day and then we apply it.*

The MM at MUN7 said feed-back from the mayor is that he continuously learn from the AC. The mayor concurs and recognised the AC assist the mayor in his oversight role over finances as well as other areas and assist the mayor in understanding the financial statements thereby adding a lot of value. The MM was complimentary about the value added by the AC but expressed the need for the AC to focus on matters over and above those presented to the AC, especially on service delivery. The CFO agreed that the AC adds particularly good value. The CAE confirmed that management acknowledges this, and he shares their opinion on the value added, specifically the advice provided. According to him, the mayor and speaker actually look forward to the meetings, especially on the focus areas being discussed.

Obtaining the views of participants and conducting the fieldwork was not without challenges. The following subsection explains some of the challenges.

#### **7.4.7 Challenges experienced**

Various challenges, although not unsurmountable, were experienced during this research. The most significant was the accessibility and availability of participants for this research. The role-players that formed part of this research, namely mayors, MM, CFOs, ACCs, AND CAEs are all busy people with priorities other than being involved with research. This resulted in scheduled meetings being re-scheduled and, in some cases, planned meetings not taking place at all. These changes in scheduled meetings also posed logistical challenges due to the long distances the researcher travelled to conduct some of the interviews. At one specific municipality, selected for this study, despite numerous attempts and re-scheduling, access proved to be extremely difficult. Eventually, a short interview was secured with the acting MM and mayor but based on observations. It was clear that they were not really interested in

sharing information. The other role-players did not even respond despite numerous attempts. Incidentally, this is also a municipality with poor audit outcomes.

To meet the objectives of this research, it was important to visit some of the rural municipalities to obtain information on the practices, practitioners, and praxis of ACs, including the challenges experienced. This resulted in a lot of travelling and resultant costs of the research.

A disappointment was the inability to secure information from AGSA members involved with the audit of the municipalities forming part of this research. Research on effective ACs has shown that the external audit and the relationship between the AC and external audit is an important determinant of effectiveness. Although the researcher intended to include the external auditors as participants of the study and applied for permission, it was not granted by the AGSA because 'the issuing of audit information obtained during the performance of the audit outside of publicly published documents, despite assurances of confidentiality places us at risk of disclosing information outside of the allowance of the PAA. In addition, we may attract pushback from auditees for having provided their information without consent'. This feedback was received late in the research process and necessitated alternative procedures to obtain information to shed some light on the view of the AGSA on ACs.

Another challenge in the research plan was the language in which interviews were conducted. Although it was planned to conduct all interviews in English, early in the process it was identified that some participants felt more comfortable to speak in their home language. To create an environment conducive to information sharing these interviews took place in the home language in which the researcher is proficient. This made the transcription process slightly more complicated and time-consuming but did not impact on the validity of the study. Where interviews were conducted in a language other than English, the researcher's translation of the interview is indicated through the use of brackets as follows '[ ]'.

Despite the challenges, valuable information on the practices, practitioners, and praxis of ACs in the cases was obtained that would otherwise not have been possible and resulted in the research objectives being achieved.

#### **7.4.8 Recommendations**

Based on the researchers own experience, document analysis, and valuable information shared by participants during discussions, it is possible to highlight possible recommendations for consideration as a contribution of this research. Throughout Chapter 7, fieldwork praxis

tips are share and indicated by this icon. These include practices and praxis implemented at municipalities or highlighted during discussions and document analysis.



The mandate and authority covered through the AC charter and embedded through strong working relationships between the different governance role-players some recommendations came to the fore during the case study. On the content of the AC charter, recommendations to further strengthen the authority and mandate include adding a statement on AC liability and steps for recourse when access to documentation or people are restricted. It is further recommended that the AC charter include a statement that the AC should not interfere with management at the municipality. The AC charter should also be published on the municipality's website to ensure the roles and responsibilities are understood and appreciated.

Due to the importance of good working relationships between the AC, the council, mayor, management, IAF and external audit, concerted efforts should be made to sustain and improve the relationships by way of regular interactions, high-quality and user-friendly communication, and quality advice and support by the AC. Working relationships could also be included as part of the requirements contained in the AC charter. The relationship between the AC and AGSA needs to be enhanced by creating the necessary platforms for building these relationships. Related to creating and improving a working relationship between the AC and AGSA is the need for clarity on the role of the AC as an independent body to evaluate the performance of AGSA. Currently, no practices at individual municipalities exist for the independent evaluation and possible recommendations that could improve the working relationships between the AGSA and various governance partners.

Another area requiring clarification and improvements relates to the induction training and professional development of ACs. No consistent, co-ordinated practices exist for the professional development, of ACs and this is not adequately covered in AC charters. Clarity on the co-ordination and funding of AC professional development is required. In this regard, the various bodies including national and provincial treasury, SALGA, Departments of Local Government and the Department of COGTA need to be involved, especially in light of the value added by ACs.

Audit composition, including the independence and expertise and experience of AC, in line with other research and best practice, is key to effective ACs. The recruitment of AC members that comply with these requirements has also been identified as the most significant and pervasive challenge for municipalities, especially at rural municipalities. A contributing factor to the difficulty in recruiting AC members raised was the low level of remuneration paid to ACs. A recommendation made in the field is to transfer the appointment and funding of ACs to provincial treasuries. A possible weakness in current practice is the disjuncture between the authority of the AC (advisory), the appointment (done by the municipality and possibility of manipulation), funding (remuneration paid by the municipality) and the municipality being able to decide what recommendations to implement or not. An alternative model where the AC is not appointed by the municipality but by provincial treasury was made. This would address the risk that AC members that are not independent or competent are being appointed and avoid possible manipulation of the appointment process. It is further suggested that the whole appointment process, including interviewing applicants, could be done by the provincial treasury.

Further, the model should include provincial treasury being responsible for funding AC-related costs. This will address the challenges of unaffordability and lack of access to competent AC members especially at rural municipalities. It can further provide for these provincial treasury-appointed AC members to report to the provincial treasury on critical matters raised during AC meetings not being addressed by council and management. The proposed model could address risks of appointing non-independent, unskilled members to the ACs. It would also address the challenges of lack of professional development, regular interactions with council, management and AGSA, and overloaded agendas due to cost containment measures being addressed. It may also be an avenue to report on those municipalities not recognising or implementing AC recommendations for further action.

On the current composition of ACs, there is a need for ICT and performance management experts and a caution against top-heavy financial experts. Municipalities expressed the need for advice on service delivery and financial management with the proviso that it is advisory and not interference.

To demonstrate adequate experience, skills, and diligence, it is necessary to disclose the qualifications of AC members and attendance as part of the AC reports in the annual reports. It is further suggested that the business interests of AC members are disclosed in the annual reports to comply with transparency related to independence.



The roles and responsibilities of ACs according to research and professional publications and demonstrated in practice, are extensive. Recommendations on the roles and responsibilities for this research include that the role of the AC in performance management, combined assurance, and ethics management need to be demonstrated in AC charters, AC agendas and minutes, and the AC reports. The AC should also be involved in practice with CAE appointments, removal, and actions for non-performance by the CAE. Performance evaluations of AC members individually and as a whole needs a thorough review and implementation guidance due to the current practices being either non-existent, inconsistent, or incomplete. The AC charter should include the requirements for performance evaluations of the AC and actions for non-performance.

Various recommendations to improve the quality and impact of AC communication and reporting have been identified throughout this research. AC reports need to indicate the independence and qualifications of AC members. The AC reports also need to include information on internal control effectiveness, the capacity of the IAF, and on the effectiveness of the finance function. The AC report should further disclose the work performed by the AC on performance management, risk management, in-year reports, ethics, fraud, IT, and compliance. The format and presentation of AC reports should be more user-friendly including visual tools, dashboards, and other means to make it digestible, highlighting the key matters and challenges for council and management to take required actions.

## 7.5 Conclusion

In answering the research question on what practice, practitioners, and praxis are associated with effective ACs in local government, the fieldwork focussed on obtaining information on the mandate and authority, composition and appointment, roles and responsibilities, formal and informal interactions, and AC communication, including reporting.

Based on the case study insights, AC practices, practitioners, and praxis add value to municipalities in different areas of responsibilities especially in the oversight and quality advice on financial information, internal control, and internal audit. The case study was able to identify several instances where the AC played a significant role in contributing to positive audit outcomes. However, the value added depends on the composition of the AC, characteristics of the AC and the ACC, authority, resources, and support provided to the AC, the relationships between the different governance role-players, and diligence. The fieldwork results indicate the AC playing a substantive rather than a ceremonial role but with shortcomings in

demonstrating performance through AC communication and reporting and adequate performance evaluations. The fieldwork revealed some gaps between legislative requirements and best practices and the practice, practitioners, and praxis in the field and some recommendations of how this can be addressed had been made.

The ACs were able to add value as a result of their composition (independent with the necessary mix of skills and experience) and through their characteristics. Throughout the fieldwork, the critical role of the ACC was emphasised. Essential characteristics for AC members and the ACC identified include independence, honesty, and objectivity, not being easily influenced, demonstrating leadership, and most importantly, displaying a strong personality through interrogation and challenging context-based questions constructively. The diligence of AC members was measured by the attendance, preparation, and participation at the meetings. However, to ensure sustained value, AC members need to keep up to date with changes and developments through professional development. Professional development of ACs and taking responsibility, therefore, seems to be a current grey area.

The most significant and pervasive challenges identified throughout the research by all municipalities is the difficulty to attract skilled and experienced members to serve on the AC, especially at rural municipalities. Possible reasons could be the perceived low remuneration paid to AC members and the potential reputational damage of getting involved at municipalities with poor governance. Other than remuneration, another variable influencing diligence relates to the time availability of AC members. Time availability is impacted by other professional responsibilities and serving on multiple ACs or boards. Participants expressed mixed views on AC remuneration and serving on multiple ACs.

The AC obtains its authority through the AC charter and further depends on the culture of the municipality, which is demonstrated by the extent to which AC recommendations are implemented. Culture in this context includes resources and institutional support and good working relationships with council, the mayor, management and the IAF, without which the ACs are unable to fulfil their responsibilities effectively. Other important resources are timely, useful, and reliable quality information, adequate time for preparation and interaction, and quality participation during meetings.

Concerning role clarity, no uncertainty featured in the distinction between advisory and oversight role and based on observations, the role of the AC differs depending on the specific circumstances at the municipality.

Although not explicitly raised by participants, an area that requires further research concerns the possible personal liability of AC members that could impact on the practices, practitioners, and praxis going forward.

The observations made during this study would not have been readily available from ordinary publicly available information sources or through surveys, which emphasises the value of a case study approach to bring context-based perceptions and information into view.

## CHAPTER EIGHT: CONCLUSION AND RECOMMENDATIONS

### 8.1 Introduction

The chapter presents the findings and conclusions from the empirical study and demonstrates how the research questions were answered and what these answers mean. The chapter also offers recommendations that, together with the findings, contribute to the academic literature and practical knowledge and insights into the practice, practitioners, and praxis of audit committees in local government to support and enhance their effectiveness in the future. The limitations of this study and possible areas to consider for further research are also provided in this chapter.

This study makes various contributions to the academic literature, including detailed insights into audit committees as practitioners, the practices followed, and praxis implemented in local government that is further described in this chapter. Although the research confirms some previous research on audit committees, it expands on the limited information available on audit committees in local government, South Africa. Finally, from a theoretical perspective, this research moves away from the traditional agency theory by using a hybrid of theories including agency, resource dependence, institutional, and practice-orientated theory.

The next section includes the main findings of the literature review, insights into audit committees as practitioners, and the practice and praxis implemented in local government, South Africa.

### 8.2 Main findings

#### 8.2.1 Literature review

A review of academic research and professional literature reveals that audit committees have been researched extensively but that most academic research focuses on audit committees in the corporate sector. Limited research on audit committees in the public sector and local government explicitly has been completed. The review of literature on audit committees in the private sector proved to be insightful. However, it is important to recognise the difference in accountability in local government being multifaceted and impacted by diverse social, political, and financial objectives.

The research studied during the literature review also suggested that more research be completed on audit committee processes in practice, which includes management, who plays a significant role in driving governance and has been ignored in earlier research, as part of the research and the body of knowledge. The need for the suggested expansion of the scope of research on audit committees was triggered by the stagnation in research, the decline in the use of research findings, and limited variation in the audit committee characteristics used in research.

The literature review also exposed the different theoretical bases used for studies on audit committees including the agency theory, resource dependence theory, institutional theory, managerial hegemony theory, practice theory, and a hybrid of theories. As a theoretical base, the agency theory is used in most studies on governance and audit committees. The agency theory in the South African local government context can be explained as follows: the shareholders (principal), through the council (governing body), appoint management (agency) to act in the best interests of the citizens/community (shareholders). Audit committees are appointed by the council as a sub-committee to assist the council in fulfilling its governance and oversight role. According to the agency theory, the independence and expertise of the audit committee members are the main required attributes of the audit committee. However, the agency theory (independent monitors of management) only presents a partial view, comprising the views of the council, audit committee, and management acting as agents, and ignores a large portion of the complexity of organisations. If this research were limited to the independence and monitoring ability of the audit committee, the scope would be limited, ignoring other significant role-players and factors impacting audit committee effectiveness. However, the extent of irregular, fruitless, and wasteful and unauthorised expenditure in local government warrants the use of the agency theory as one of the theoretical perspectives of this research.

The use of resource dependence theory addresses the limited focus on controlling management by concentrating more on the assistance provided by audit committees in bringing valued resources in the form of advice and counsel. The valued resources include the resource-rich members serving on audit committees and network ties to other external resources. This was particularly appropriate in this research where participants valued the assistance provided by the audit committees in their dealings with the AGSA. The resource dependence theory is also particularly relevant for this research in that it is a legislative requirement for the audit committee in local government to play an advisory role to both the council and management. The audit committee, being a sub-committee of the council within local government, needs to bring skills to the council in the areas where the council members

lack them, including the areas of internal controls, risk management, and governance. Although research indicated that the resource dependence theory is less used as a theoretical perspective to study governing bodies when compared with the agency theory, the empirical evidence suggests that it provides a more effective method to understand governing bodies. The limitations of both the agency theory and resource-dependence theory (the restricted view) prompted the approach to combine the two theories.

Another theoretical perspective used in audit committee research is the institutional theory, which presents audit committees playing a ceremonial role rather than a substantive role to provide legitimacy to the organisation. The results of previous research indicate a mix of substantive and ceremonial practices and conclude that neither agency nor institutional theory thoroughly explains the research results and recommends a hybrid of elements of the agency and institutional theories to enable a better understanding of audit committees. One of the objectives of this research is to determine whether audit committees provide substantive oversight or merely fulfil a ceremonial role to create legitimacy. For that purpose, the institutional theory is essential.

The other perspective, the managerial hegemony theory, argues that if senior management appoints colleagues or acquaintances as audit committee members, they will not restrict management and will not play an active role in overseeing management as part of governance. This perspective was considered in this research by gathering information on the audit committee appointment process, the role of management, and members being appointed.

The literature review further revealed the need for contextual research or field studies on audit committees due to different and unique cultures, politics, economics, and social influences. This necessitates the research on the practices and processes and interactions between different governance role-players for more meaningful research and to improve governance practices supporting the practice-theory perspective. The framework of practice theory used in the more recent research on audit committees by Brennan and Kirwan (2015) and used in this research includes three components, namely practice, practitioners, and praxis. This has the benefit of providing alternative insights and recognises the dynamic, interactive nature of governance and the need to capture real-world situations; an area which has been explored to a limited extent.

Based on the description and limitations of the various theories, selecting one specific theory would limit the knowledge generation and provide a limited view. If used in a multi-theoretic

approach, the different theories can be complimentary and be used to generate a more comprehensive understanding of governance, resulting in recognising the various mechanisms and structures that could enhance organisational functioning and explain interactions. The use of a combination or hybrid of theories have been supported by researchers and can counter the shortcomings of using one of the perspectives only. Specifically, when the complexity of the local government environment is considered, the use of a hybrid theoretical model could provide new insights into the research on the effectiveness of audit committees. For this research, a hybrid of agency, resource dependence, institutional, and practice theories are used. The agency perspective requires the audit committee to be independent and monitor management on behalf of the council. The institutional theory professes that audit committees, by their mere existence, provide legitimacy and play an important symbolic role without actual monitoring taking place. During this research, the relevance of the institutional perspective was tested by acquiring information on the role management plays in the appointment of audit committee members and the audit committee being one of the many role-players, including the Auditor-General, contributing towards governance. The composition of audit committee members and acquiring scarce skills serves as a resource to the council in advising and sharing information to assist the council in performing oversight, making the resource dependence theory relevant. Research recognises continuous development in governance influenced by culture, history, economics, and social factors, necessitating the understanding of processes and the link with outcomes and interactions in the specific context supported by the practice-orientated theory. The interpretative views of the four theories were used as a basis to identify and refine the determinants of effective audit committee practitioners, practices, and praxis and used as part of the analysis discussed in Chapter 7.

Literature was also reviewed to obtain a body of knowledge on research studies on audit committees in both the private and public sector. The literature review revealed that the roles and responsibilities of audit committees evolved and expanded considerably over time. A useful framework to present the literature on audit committee research and developed by Brennan and Kirwan (2015:467) and used to present this study's literature review on audit committees, distinguish between practices, practitioners, and praxis. Practices refer to rules and procedures, while practitioners refer to the audit committee members, ACC, and other governance practitioners. Praxis refers to the activities where practitioners combine and adapt practices for the specific context and apply them in practice.

Researchers recognised the complexity of studying audit committee effectiveness and the variety of factors influencing effectiveness. The literature review of audit committees in the



private sector showed research on practices mostly focussed on the existence and composition (independence and expertise) of audit committees, the ceremonial role versus substantive monitoring, and the interaction and relationship between the audit committee and other role-players, specifically internal and external audit. Research was also performed on the practices carried out in audit committee meetings and found key matters on which audit committees focus during meetings are financial statement accuracy, the effectiveness of internal controls, and the quality of work performed by auditors. Although the importance of standardised structures, formal requirements, and practices were recognised in research, it was identified that effectiveness does not rely solely on these externally verified characteristics. Factors such as audit committee characteristics, actual processes including informal processes, interpersonal relationships, power structures and the influence of the audit committees were also identified to be relevant for effective audit committees. If the focus is limited to audit committee practices, there is a risk that the research only studies the appearance of governance and not the substance.

The literature review further indicates that research evolved to include studies on audit committees as practitioners and how practices are applied and transformed, resulting in praxis. On practitioners, the often-quoted study by DeZoort et al. (2002:42) identified composition, authority, resources, and diligence to be essential for audit committee practitioners in fulfilling their roles and responsibilities effectively. The literature review also showed research focussed on the whole audit committee, individual members, or the ACC and the leadership style and the view of different stakeholders including the audit committee members themselves and external audit on their effectiveness.

Research studies on the composition (independence, expertise, integrity, and objectivity) of audit committees and the impact on effectiveness was a focal point of audit committee research between 1998 and 2004. Independence and the need for audit committees to be independent was one of the most 'popular' variables in the audit committee composition research. Required audit committee member expertise as part of the composition determinant was another often-studied variable. At that time, the studies indicated significant variation in expertise within and among audit committees and that many members lacked adequate experience and expertise in the oversight areas.

The authority of the audit committee and the impact on effectiveness was another topic of research elevated by the literature review. The research showed diverse audit committee responsibilities, the most important being oversight of financial reporting, auditing, and internal controls. Research indicated the audit committee obtained its authority through the audit

committee charter and managements' support. The literature review showed resources to be another enabling factor for effective audit committees and focused on support from external and internal audit and the size of the audit committee.

The literature review revealed that diligence was one of the most important audit committee effectiveness attributes. However, the criticism raised against research on the diligence of audit committees was the measurement of diligence focussing on the number of audit committee meetings per year, while ignoring factors such as audit committee motivation and incentives or the impact of penalties, for example, litigation and reputational damage. Diligence was explained in the research to include the level of preparation and activity, vigilance, and independence.

Other research examined the effects of audit committees rather than their effectiveness including the link between adoption of audit committee structures or characteristics and achievement of specific governance effects including the audit function, financial reporting quality and corporate performance. The research evidence showed mixed results and the need for research on the difference audit committees make in practice and in the institutional contexts in which audit committees operate to be able to consider the relational dynamics and interaction between the audit committee and other structures within the entity.

Later research on audit committees (between 2007 and 2017), according to the research need identified, began focussing on praxis, which includes the actual operations, processes and activities of audit committee members and the chairperson within the specific context. This necessitated obtaining the views on audit committees from the small group of people who deal with the audit committee, including CEOs, CFOs, CAEs, external auditors, ACCs, and AC members by way of field studies. Research was completed on interpersonal relationships and interactions between audit committee members and governance practitioners, informal processes and interactions, selection of audit committee members, the meeting process, and personal and entity characteristics. The research showed variances among individuals when reflecting on the effectiveness of processes and results. The importance of studying within the specific context was highlighted.

Research showed the trust relationship between the audit committee, management, and internal and external audit were all important considerations under the praxis of effective audit committees.

The culture of the organisation that encourages informal interactions between different functions in the organisation and the audit committee is perceived to impact positively on governance outcomes.

The findings of the research on praxis would not have been possible if quantitative measures were used and by using qualitative techniques, the potential to obtain a more substantial contextual understanding of the audit committees' praxis was possible.

Research showed key matters discussed during meetings emphasised the accuracy of financial statements, the effectiveness of internal controls, and the quality of work performed by the auditor.

Another theme of research is the role of the audit committee in auditor-management disputes. Although limited research has been conducted on audit committees in local government, findings similar to research in the private sector, including the importance of independence, financial skills and expertise, organisational experience, relationship with stakeholders, clarity of purpose, and willingness to commit time were examined. The capabilities of the ACC, similar to the research in the private sector, was also found to play an important role in adding value. The view of governance role-players on the effectiveness of audit committees, including internal auditors, external auditors, and senior management, were obtained. The impact of the audit committee outside formal interactions proved to be very valuable. Researchers also found the organisational culture to play a role in the effectiveness of audit committees, including buy-in on the roles and responsibilities of the audit committee and important characteristics to include objectivity and personal integrity. The effectiveness of audit committees in the area of monitoring of internal audit, risk management, and engaging with external audit were some of the areas analysed. Enabling factors such as authority and resources are some of the pre-conditions for effective audit committees. The need for procedures to assess audit committee performance if the audit committee is to work effectively has also been identified

During the literature review it was noted there was a continuous call for research into audit committees taking the specific organisational context into consideration, which was answered in this research through the fieldwork conducted. These findings are summarised in the next section.

### 8.2.2 Fieldwork

The findings from the field research, discussed in chapter 7, conclude the audit committees add considerable value through oversight and quality advice provided to the council, mayor, management, and internal audit and contributes significantly to positive audit outcomes. The perceived value added is broad and varied and includes improved accountability, oversight, and quality advice in different areas of responsibilities, but particularly on financial reporting, internal control and internal audit, an independent forum to facilitate issues between the AGSA and management, acting as additional assurance providers, assisting and increasing the credibility of internal audit, advising the finance department, and improving the quality of financial information for audit purposes.

Most participants, supported by the document review including agendas and minutes of meetings, agreed that all areas of responsibilities including finances, internal control, internal and external audit, risk management, performance management, compliance, ethics, and combined assurance are important. The fieldwork also showed the focus of the audit committee is determined by the specific context, including the risks and challenges at the municipality at a particular point in time, and could change as a result. Despite context-specific focus, transversal high-focus areas also came to the fore during discussions. The most important was the role of the audit committee in overseeing the financial process and financial information.

Despite the positive view of value added by the audit committee, various participants expressed the need for audit committees to play a more advisory role in financial management, including providing support in financial budgeting and financial decision-making. The audit committee, if it is fulfilling the legislative function of a performance audit committee, also needs to provide advice on performance management. Participants expressed their need for the audit committee to become more involved with advising on service delivery rather than focussing on compliance only. Audit committee reports indicated different statements on the responsibilities and actions by the audit committees on performance management. Further research is required on role clarity of financial management and performance management responsibilities of the audit committee, including role clarity, taking cognisance of the requirement not to interfere with management responsibilities.

The research further indicated the value added is dependent on the composition of the audit committee, characteristics of the audit committee and the ACC, and the authority, resources, and support provided to the audit committee.

In analysing practitioners and composition, the audit committee's mix of experience and expertise in finance, auditing, risk management, performance management, and local government is considered to be an important contribution to the value added. Because of the extensive areas of audit committee responsibilities (see Chapter 4), the importance of a combination of skills and experience to be able to fulfil their roles and responsibilities effectively is a logical deduction and was confirmed by participants in the cases. Expertise and experience, particularly in the area of finance, was viewed by participants to be key; however, caution against having an audit committee that comprises of a majority of financial experts was raised. The emphasis on required financial expertise on the audit committee is understandable in light of the challenges being experienced in implementing GRAP standards. The almost over-emphasis on obtaining clean audit opinions, sometimes to the detriment of service delivery (expressed by participants), provides a further basis for the emphasis on having the necessary financial experience and expertise on audit committees. In general, participants were satisfied with the composition of the audit committees but recommended that improved expertise was required in the areas of IT and performance management. Despite the importance of an audit committee comprising of a mix of highly-skilled and experienced members expressed in research on audit committees and confirmed by the participants of this study, very few audit committee reports disclosed the qualifications and skills-set of the audit committee members. Performance management and IT were identified as areas where the experience and expertise of audit committee members need to be enhanced. Expectations should, however, always be managed within the context of the structure and composition of the audit committee, being part-time and meeting between four and six times a year and the organisational context including the culture, resources, and support provided to the audit committee.

However, the most significant and pervasive challenges identified throughout the research by all municipalities is the difficulty to attract the required skills and experience of members to serve on the audit committee, especially at rural municipalities. IT governance was highlighted as a specific scarce skill. Possible reasons could be the perceived low remuneration paid to audit committee members and the potential reputational damage of professional members becoming involved at municipalities with poor governance, which is very unfortunate because these are the municipalities where value-adding services are mostly required. Due to the recruitment challenge identified, the appointment processes of AC members at the different municipalities were researched. The results indicate various practices and praxis are followed in the appointment and approval processes of audit committee members and ACCs. Some municipalities in the research also revert to head-hunting including calling upon previous contacts, colleagues, and acquaintances. This praxis could impact on the perceived

independence of audit committee members, identified by participants as a fundamental characteristic. Despite the potential risk of appointing non-independent audit committee members, various practices mitigating the risk were identified as part of this research. These include the legislative requirement that audit committee members cannot be employees of the municipality, the rigorous and transparent appointment process, audit committee members signing independence declarations at every audit committee meeting, the maximum two-term tenure restriction, and all audit committee charters including a statement on independence.

Audit committee members possessing the required skills and experience were not considered the only determinant of effective audit committees. Throughout the fieldwork, the critical role the ACC play in adding value was recognised by participants. Participants in the cases identified the most important characteristics for audit committee members, and the ACC is to display a 'strong' personality and act with honesty and integrity in fulfilling their responsibilities. A strong personality is demonstrated through interrogation and posing challenging context-based questions constructively. Other characteristics identified by participants include members and the chair not being easily influenced, and demonstrating leadership were also considered to be important features of audit committee members.

Other than composition and characteristics, participants also viewed the diligence of audit committee members to be an important feature in measuring the effectiveness of audit committees. According to participants, the diligence of audit committee members was demonstrated by the frequency of meetings and attendance, preparation, and participation at the audit committee meetings. A praxis that has proven effective at some of the cases is to assign specific parts of the audit committee agenda information to individual members based on their area of expertise. The members would then take responsibility to study, prepare, interrogate, and ask questions at the meeting, using the allocated information or area. The remuneration of audit committee members has been indicated as a variable that could affect diligence. Another variable of diligence relates to time availability of audit committee members. Time availability can be impacted by other professional responsibilities and serving on multiple audit committees or boards. Participants expressed mixed views on audit committee remuneration and serving on multiple audit committees. One school of thought was that remuneration should not be a factor in decisions to serve on audit committees or impact diligence. In contrast, the proponents for fair remuneration, including all three ACCs interviewed, recognise the need for fair remuneration to ensure the required skills and experience are attracted. The reasons members serve on audit committee include having a vested interest, for example, owning property in the municipal area or as part of social

responsibilities, which will not necessarily be a sustainable reason for serving on audit committees in the future.

Other observations on practitioners, related to members with the required expertise and experience, are the current sometimes non-existent, inconsistent, and un-coordinated practices for the professional development of audit committee members expressed by participants. Continuous induction and relevant training and professional development in a consistently changing environment and having local government and municipal-specific experience were recognised to be important for effective audit committees. However, various views on the custodians and funding of this responsibility were expressed. Some participants viewed it to be the responsibility of the audit committee members themselves. In contrast, others were of the view that the municipality, other interested local government bodies including national and provincial treasury, SALGA, or a combination should take responsibility. This area was also not adequately covered in the audit committee charters.

Different evaluation practices, or in some cases none, for the performance of audit committees, are implemented. Performance evaluations could be valuable to identify some of the shortcomings or expectations identified by participants and provide an opportunity for audit committee members to change practices and praxis. There is a need for a complete review and overhaul of performance evaluation of audit committees.

On practices and praxis, the need for audit committee authority, support, and resources were identified as enabling factors for effective audit committees in this research. The fieldwork suggested that the power and authority of the audit committee are contained in the audit committee charters approved by the council, which gives the audit committee unrestricted access to information and people. Participants also acknowledged the culture of the municipality plays an integral part in providing authority to the audit committee and is visible by the extent to which audit committee findings and recommendations are implemented. The culture referred to includes institutional support, resources provided to the audit committee, working relationships, and personalities.

Institutional support and resources include, firstly, the supportive tone and attitude of management, council, and internal audit that was observed at most of the cases. The ACCs and participants from the municipalities shared the importance of having unrestricted access between the audit committee, council, management, and internal audit through formal and informal interactions. Secondly, access to useful and reliable quality information was identified as another important resource for the audit committee. The CAE plays an important role in



this facilitation and enables the audit committee members to prepare for the meetings properly. A beneficial praxis identified at some of the cases is the informal interaction among audit committee members taking place before the meeting that enables them to be well-prepared and communicate as a collective. Thirdly, time is another important resource and includes preparation time, meeting time, and interaction time. In general, participants expressed satisfaction with time as a resource. An area that has been identified for further consideration and research is the current limited use of outside advisors as an additional resource to the audit committee.

Good relationships between the audit committee, council, the mayor, management, the IAF and external audit were identified as another important enabler for effective audit committees. Participants considered open and honest relationships that built trust through, among other things, regular interactions between the parties to be an important contributor to the value being added by audit committees. The style of communication during these interactions was also recognised as important to influence and get buy-in from the different role-players. Participants viewed the working relationships between the various parties as healthy and appreciated the value of the regular interactions. However, participants suggested improvements in communication with council, particularly in the audit committee reporting to the council being more user-friendly and visual together with occasional attendance by audit committee members to explain and provide additional information. Cost containment, however, could again be a limiting factor in introducing these recommendations.

The relationship between the various role-players and AGSA, external audit, was identified as very important. The fieldwork and views of participants indicated this relationship to be strained. In general, interaction is limited between the audit committees and AGSA, other than the meetings when the AGSA presents the audit strategy to the audit committee and management and when the draft audit report and audit opinion are presented to the audit committee. It was, however, noted that increased interactions have been taking place mainly as a result of differences or disagreement between management and the AGSA on audit findings and interpretations where the ACC or audit committee played a much more significant facilitation role.

The observations made during this study would not have been readily available from publicly available information sources or through surveys. The case study methodology enabled the researcher to bring context-based perceptions and information into view.

## 8.3 Answering the research questions

### 8.3.1 Primary research question

The research focus and primary research question was to determine what practice, practitioners, and praxis are associated with effective audit committees in local government, South Africa.

The study found that audit committee practices, in general, are sound and in compliance with legislative requirements, the King IV corporate governance code of South Africa, other audit committee guidance documents issued, and the audit committee charters. Participants of this study indicated satisfaction with the frequency and scope of the formal audit committee meetings, with some concerns expressed on agendas being overloaded because of cost-saving measures. The agendas of the meetings largely covered the roles and responsibilities of the audit committee set out in the audit committee charters that were found to be in line with best practice. Focus areas during meetings included financial information, AGSA findings and follow-up, review of internal audit progress against the plan and reports, risk management, and performance management. The one area where a complete examination and revised design and implementation is required is audit committee performance evaluations that are either non-existent or where shortcomings in application have been identified.

### 8.3.2 Secondary research questions

The analysis of audit committee members as practitioners includes the composition, authority, resources, and diligence of audit committees in fulfilling their roles and responsibilities effectively. Several of the secondary research questions raised relate to the audit committee as a practitioner, including:

- Secondary research question 1 - How does the current composition of audit committees that include expertise and independence, impact on the effectiveness of audit committees?
- Secondary research question 2 - Are municipalities able to attract persons to serve on audit committees that have sufficient knowledge, skills, and experience in the required areas?
- Secondary research question 3 - Do audit committees appear to provide substantive oversight, or do they seem to be primarily ceremonial bodies designed to create legitimacy?

- Secondary research question 4 - Do audit committees have the necessary relationships, authority, and organisational support to ensure effective execution of their roles and responsibilities?
- Secondary research question 5 - How do audit committees demonstrate the effective performance of their roles and responsibilities?
- Secondary research question 6 - Is there a gap between what is required of audit committees in terms of legislation and best practice and the expectations of stakeholders?

#### *8.3.2.1 Secondary research questions 1 and 2*

The results of the empirical research indicated the need for audit committees to comprise of a mix of experience and expertise mainly in the areas of finance, auditing, risk management, performance management and local government; the most important being the area of finance. The cases in this study generally revealed satisfaction with the mix of skills and experience to manage audit committee responsibilities and activities, except in the areas of IT and performance management. However, the challenge lies in difficulty to attract the required skills and experience of members to serve on the audit committee, especially at rural municipalities.

Skills and experience are not the only identified requirement for audit committees to fulfil their roles and responsibilities effectively. Participants recognised audit committee members and the ACC need to be honest and have integrity, display a strong personality and actions constructively in which they interrogate management by way of challenging, context-based questions. Diligence, demonstrating leadership, not being easily influenced, and understanding local government was also considered to be very important. Perceived diligence was measured through attendance and frequency of audit committee meetings and being prepared for and active participation during the meetings.

Praxis refers to the actual activities and processes in practice. Documentation reviewed and the view of participants confirmed all areas of audit committee responsibilities including finances, internal control, internal and external audit, risk management, performance management, compliance, ethics, and combined assurance are important. The research, however, showed the focus of the audit committee is also informed by the specific risks and challenges at a municipality at a particular point in time and would therefore not necessarily be consistent over a period. Participants were satisfied with the audit committees effectively

fulfilling their roles and responsibilities at municipalities. However, areas where the audit committee should become more involved with or contribute, were suggested by participants.

Some participants expressed the need for audit committees to become more involved with financial management rather than focussing on the review of financial information and financial statements only. On internal control and control environment, the need for the audit committee to be more involved with the appointment, removal and performance evaluations of CAEs were expressed.

Although advising on performance management is a legislative requirement, the documentation review indicated performance management responsibilities are not wholly and consistently covered in audit committee charters. Reports and participants mentioned a lack of audit committee skills and expertise in this area. Various participants also expressed the need for assistance by the audit committee on service delivery issues rather than the compliance focus.

#### *8.3.2.2 Secondary research question 3*

Fulfilling required roles and responsibilities together with demonstrated diligence, the rigorous appointment process, and intensive informal and formal interactions indicated a commitment to substantive monitoring rather than just playing a ceremonial role as confirmed by the ACCs and participants in the cases of this research.

#### *8.3.2.3 Secondary research question 4*

Research on praxis and the enabling factors for effective audit committees include the importance of working relationships, authority, and organisational support. The empirical evidence showed the audit committee charter, setting out the roles and responsibilities, and approved by the council provides power and authority to the audit committee. The power and authority of the audit committee is further enhanced through the culture of the municipality and demonstrated by the extent to which audit committee recommendations are implemented. Factors that can be grouped under organisational culture, providing the audit committee with power and authority, include institutional support, working relationships between the audit committee and other governance role-players and personalities. Power and authority to discharge their responsibilities are further provided by having access to municipal records and additional information and the ability to request relevant persons to attend meetings and provide information. Participants recognised and appreciated the audit committees having

unrestricted access to representatives of council and management through formal and informal interactions.

Because the audit committee performs an advisory function, participants viewed good working relationships between the audit committee, council, the mayor, management, IAF and external audit as key to audit committees being able to be effective and add value. The need for the relationship to be open and honest and built on trust through regular interactions between all these role-players was considered essential. The view was held that interactions, especially frequent informal interactions, enables building such a relationship. The communication style was also identified to play a role in building these relationships, being constructive rather than dominating. Participants believed that good working relationships existed between the various parties with regular interactions including honest feedback. An area where improvements are required and identified during the research was in communication, both written and oral, with the council. The current relationship and communication between the audit committee, management, and the AGSA was recognised as another area where relationships need to be improved.

The supportive tone and attitude of management, council, and internal audit was considered an important resource for the audit committee, without which they would not be able to fulfil their responsibilities. Another resource acknowledged was receiving timely, useful, and reliable quality information. The CAE plays a key role in ensuring the audit committees have access to information. An important beneficial praxis recognised by some participants is the informal interaction among audit committee members before meetings that enables them to be well-prepared and communicate as a collective. Another praxis implemented by some of the audit committees is to allocate specific parts of the audit committee agenda to individual members based on their area of expertise, to raise questions and lead the discussion on those particular areas during the meeting. The pre-meetings between the audit committee and internal audit without management being present also provided the opportunity to inform the audit committee about areas requiring specific attention during the meeting or any other challenges the CAE considers to be important for the audit committee to be aware of. Most of the audit committees comprised of the minimum required number of members. However, this was not raised as a challenge during the fieldwork.

A challenge on resources and support to audit committees raised relates to the induction and professional development of audit committee members. Participants agreed that it is important, and there is a need for it, but there were mixed views on who should take responsibility and carry the cost for the training and development. Training and professional

development was also not adequately covered in the audit committee charters. The current efforts for professional development are limited and uncoordinated. Recommendations were made on how professional development can be encouraged, monitored, and improved by involving more parties and organisations with an interest and responsibility towards local government governance.

Time, including preparation time, meeting time, and interaction time was considered another important resource of the audit committee. The empirical evidence revealed adequate preparation and meeting time. However, some participants believed that effort over and above what was required by audit committee members was not always demonstrated. This could be as a result of serving on audit committees not being a full-time priority professional responsibility and the low levels of remuneration.

#### *8.3.2.4 Secondary research question 5*

Another secondary research question this research attempted to answer is how audit committees demonstrate the effective performance of their roles and responsibilities. Two possible means the audit committees can use is the performance evaluations and the ACS communication by way of audit committee reports to the council, the public, and management. The research revealed room for improvement in both areas. Performance evaluations in many instances do not take place at all or are ineffective. Participants were also not entirely satisfied with how the audit committee communicates with the council through their reports and interactions. The research also indicated various areas where improvements in the audit committee report, included in the annual report, and therefore a public document can be made.

Throughout the research, cost containment and cost implications on recruiting the appropriate practitioners and implementing certain practices and praxis emerged as possible obstacles. On practitioners, the challenge of recruiting audit committee members with the appropriate skills and experience especially at rural municipalities proved to be a significant challenge, and one of the possible reasons provided is the low remuneration paid to audit committee members. Currently, the use of outside advisors to augment the skills and expertise of the audit committee is limited, possibly due to the additional costs involved. Another challenge related to audit committee members is the lack of induction training and professional development, one of the reasons being the cost implications and uncertainty on who should take responsibility for carrying the cost. On practices, one of the criticisms expressed was the sometimes-overloaded agendas, possibly as a result of attempting to prevent additional audit committee meetings and the resultant additional travel and audit committee remuneration

costs. Although the benefit of regular interactions, especially informal interactions, to build an honest, open, and trusting work relationship between the audit committee, council and management is recognised, the cost implications could prevent it from happening as regularly as it would be considered necessary. On praxis, improvement in the content and tools of communication with the council, including physical presentations, was identified as an area that needs improvement. However, this would also mean additional costs to the municipality.

#### *8.3.2.5 Secondary research question 6*

The fieldwork on the research question of whether there is an expectation gap between what is required in terms of legislation and best practices and what is expected by stakeholders, brought to light some deficiencies in the practice, practitioners, and praxis in the field and recommendations on how this could be addressed are included in the next section. However, audit committees are considered to add value to the municipalities and be an important role-player for strengthening corporate governance at municipalities. Value is especially added in achieving positive audit outcomes through the review of financial and performance information and by the oversight and advice on internal control and internal audit.



## 8.4 Recommendations

It is acknowledged that as audit committees continue to develop, and different individuals with varied skills, expertise and characteristics serve as members, different practices and praxis might emerge. However, this should not weaken the recommendations, conclusions, and specifically the significance of the findings of this research.

Chapter 7 includes recommendations for consideration based on the fieldwork and information shared by participants, document analysis, and the researcher's own experience. Throughout Chapter 7, fieldwork praxis tips are shared and indicated by this icon.



This section only provides a high-level summary of the recommendations detailed in chapter 7.

Recommendations include:

- 1) expand the audit committee charter to include a statement on audit committee liability, non-interference with management, steps to be taken when access to information and people are restricted, important working relationships with key stakeholders and the maintenance thereof, roles and responsibilities of the audit committee related to performance management, combined assurance and ethics management, requirements for performance evaluations of the audit committee and actions for non-performance, and publish the audit committee charter on the municipality's website as one of the tools to contribute towards role clarity.
- 2) Sustain and improve work and external audit by way of regular interactions, high quality and user-friendly communication, and quality advice and support by the audit committee in the most cost-effective manner.
- 3) Create a platform for building relationships between the audit committee and AGSA.
- 4) Provide an opportunity for the audit committee together with management, to evaluate the performance of AGSA and provide feedback.

- 5) Design and recommend a consistent, co-ordinated practice for the professional development of audit committees with due regard to funding possibilities and input from various bodies with interest in good governance at municipalities including national and provincial treasuries, SALGA, Departments of Local Government and the Department of Cooperative Governance and Traditional Affairs.
- 6) Assist with the sustained recruitment of independent, adequately skilled and capacitated audit committee members, including IT and performance management, consider transferring the responsibility of appointing and funding audit committees to provincial treasuries addressing the challenges of access and affordability of competent audit committee members especially at rural municipalities and the possibility to accommodate the need for the expanded scope of audit committees expressed. Critical governance matters raised during audit committee meetings not being addressed by council and management could also be elevated, and other important practices and praxis such as professional development, regular interactions and communication with council, management and AGSA, and reduced overloaded agendas due to cost containment measures would be possible.
- 7) Expand the information disclosed in the audit committee report by disclosing qualifications of audit committee members, meeting attendance, and independence statement and disclose the business interests of audit committee members in the annual reports to demonstrate transparency and independence. Provide information in the audit committee report on how the audit committee fulfilled its responsibilities in all areas of responsibility, including performance management, risk management, in-year reports, ethics, fraud, IT, and compliance. Include a statement on internal control effectiveness, the capacity of the IAF and on the effectiveness of the finance function.
- 8) Reports and communication with council should be user-friendly, visual, and understandable for non-financial experts and include key matters and challenges for council and management to be aware of.
- 9) Involve the audit committee with CAE appointments, removal, and non-performance by the CAE.
- 10) Provide guidance on best practice performance evaluations for audit committee members individually and as a whole.

## 8.5 Contributions of study

One criterion for excellent qualitative research, according to Tracy (2010:845-846), is the need for the research to make a significant contribution by capturing, among other things, how practitioners cope with problems in the specific situation and provide suggestions that could help participants and other practitioners to develop normative principles about how to act. To measure a significant contribution, it is necessary to evaluate if the study extended knowledge, improved practice, opened avenues for ongoing research, and empowered readers of the research.

This study extended knowledge in that it is, as far as could be established, the first qualitative study on the practices, the practitioners, and praxis associated with effective audit committees in local government in South Africa using the case study approach and incorporating my story (autoethnography). A new avenue in the research approach was also followed by using a hybrid of agency, resource dependence, institutional, and practice-orientated theory.

The study includes recommendations and fieldwork praxis tips for consideration based on the research, information shared by participants, document analysis, and the researcher's own experience. An attempt was made to provide a thicker level of description of fieldwork perceptions and observations for readers to assess how well these research findings may fit into their municipal context. Various areas of future research are suggested in the next section.

By following a case-study approach, the researcher was able to bring context-based observations, perceptions and information into view that would not have been readily available from publicly available information sources or through surveys and by way of theorisation or policy development. Ten significant factors that affect the contribution made by audit committees to governance outcomes have been identified. First, the most significant areas in which practices, practitioners and praxis add value to the municipalities were in the oversight and quality advice provided to the council, mayor, management and internal audit on financial reporting, internal control and internal audit contributing towards positive audit outcomes. Second, the authority of the audit committee is sufficient in that the mandate is documented in the audit committee charter and approved by council. Authority is further established through the supportive culture and good working relationship between the audit committee, council represented by the mayor, management, and the IAF. Third, informal processes and interactions are considered necessary in building trust relationships. Fourth, the value added by audit committee is dependent on the composition of the audit committee including independence and mixed skills and experience in the areas of finance, auditing, risk

management, performance management, and local government. Audit committees need more experience and expertise in IT and performance management. Fifth, the value added is further dependent on characteristics of audit committee members and the ACC; the most important is to display a strong personality through interrogation and challenging context-based questions constructively. Other required characteristics are honesty, objectivity, not being easily influenced and demonstrating leadership. Sixth, the ACC plays a critical role in the value added by audit committees. Seventh, the diligence of audit committee members was measured by attendance, preparation, and participation at the meetings but professional development of audit committees and taking responsibility therefor is currently a grey area. Eighth, a major challenge is the difficulty to attract the required skills and experience of members to serve on the audit committee, especially at rural municipalities. Possible reasons could be the perceived low remuneration paid to audit committee members and the potential reputational damage by serving on audit committees at poorly governed municipalities. Ninth, the focus of the audit committee could continuously change and is context-specific based on risks and challenges at the municipality at a specific point in time. However, transversal high-focus areas were identified, the most important being overseeing the financial process and financial information. Lastly, the study identified various areas in which the audit committee could play a more significant advisory role.

The practices, practitioners, and praxis documented in this study can provide a benchmark against which other audit committees can be evaluated. It could also assist the regulators.

From a regulatory perspective, this research may also sensitise regulators about research on practices, practitioners, and praxis in the field and assist regulators in assessing the extent to which audit committee practices meet their expectations. Regulatory changes should be based on and informed by an understanding of how the main role-players involved with the audit committee, experience and perceive effectiveness.

The next section observes the limitations of this study.

## 8.6 Limitations of study

The first limitation identified was the limited previous research on local government audit committees, both internationally and nationally, reducing the research base from which to conduct research. Although recognised as a limitation, it created an opportunity to extend the

academic knowledge on the practices, practitioners, and praxis associated with effective audit committees at selected municipalities.

Secondly, it would have been ideal to attend audit committee meetings and observe the practices, practitioners, and praxis in action. However, this would have been difficult from a logistical perspective due to the sample size, location of municipalities selected, and the fact that audit committee meetings are usually only conducted on a quarterly basis. The possible limitation was offset by conducting interviews with the various attendees at the meeting, through personal experience, and by working through meeting documentation, including agendas and minutes of meetings.

Another limitation relates to the participants interviewed. Interviews were limited to the ACC and did not include audit committee members. Due to non-availability or non-response, interviews with CFO's were restricted to four of the seven municipalities. A disappointing limitation was the inability to obtain information from the external audit (Auditor-general's office). However, alternative procedures were conducted to compensate for the lack of interviews.

Due to this research being a qualitative study, it is not possible to generalise as a result of the limited number of participants and the non-random selection of cases. However, the advantages of the context-based information obtained through this research outweighs the possible limitation of not being able to generalise.

It is not possible to guarantee that the participants were candid in their responses or that responses were not influenced by individual relationships with council and management and different levels of competencies, capabilities, and capacities. However, this risk is considered low because the thematic areas were discussed with different participants at the same municipality and the quotes included in Chapter 7 demonstrate the level of openness that was evident throughout the interview process. Furthermore, measures were taken to capture accurately, transcribe, code, and analyse the information.

As a case study, the generalisation of the findings may be problematic due to the evidence reported being specific to the selected cases creating a research bias. However, the research has practical application and could be used for comparative analysis by other local governments in the province forming part of this study and other provinces in South Africa, taking the specific environmental context into account.

## 8.7 Future research

There is considerable scope for further study on audit committees in the public sector and local government. Areas for consideration on which only limited information is available is described below.

Due to the transversal and pervasive challenge of recruiting adequately skilled and experienced, diligent members to chair and serve on audit committees at rural municipalities, research on the reasons, impact, and possible actions to be taken to address this challenge could be conducted. Possible focus could include requirements of obtaining experience and expertise versus formal independence, and limitations including current restrictions on a maximum tenure of six years or members being allowed to only serve on three audit committees and preventing employees in the public sector to serve on audit committees and being remunerated for their services.

Another possible related topic for future research is the feasibility of using external advisors to augment the skills and expertise of audit committees, the extent to which outside advisors are used, the types of support provided, reasons for the lack of making use of outside advisors, and possible challenges in making use of this opportunity.

Although not explicitly raised by participants, an area that emerged from this research is the personal liability audit committee members may incur while fulfilling their extensive oversight and advisory roles and responsibilities. Research on the personal liability and how that could impact on the practices, practitioners and praxis going forward could be analysed.

Research on audit committees could be expanded to include other interested parties such as the MPAC, Portfolio Committees on Finance and Management Services, provincial and national treasury, and the broader community.

The importance of communication by the audit committee has been elevated in this research. Further research on what, how, when and to whom audit committees should be reporting to meet the needs of different users and readers taking cognisance of possible personal liability could prove to be very valuable.

During this research, participants expressed the need for additional consultative advice from the audit committees on financial management rather than reviewing financial information only. The specific requirements and needs, the impact of involvement on independence, and

the possible perception of interference with decision-taking could form an interesting topic for research.

Another valuable area of research is the professional relationship between the audit committee, management, and the AGSA at local government. Sub-themes could include the expectations and clarity on responsibilities, including evaluation of the performance of the external auditors, and approval of audit fees. Especially in light of the new Public Audit Amendment Act (5 of 2018) (RSA, 2018) , where the mandate of the AGSA has been expanded, the need for creating platforms where healthy and necessary relationships can be build needs to be further explored and should form part of future research.

The fieldwork has indicated various implementation practices on the evaluation of audit committee performance ranging from ad hoc evaluations, limited evaluations, or absence of evaluation to satisfactory practices. Performance assessments are also conducted by provincial and national treasury and other government departments. This has been identified as an area where a complete review needs to be done, and recommendations made could be valuable research in practice.



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**ANNEXURE 1: - SUMMARY OF POST GRADUATE RESEARCH ON AUDIT COMMITTEES IN THE PUBLIC SECTOR**

<b>Ref</b>	<b>Title</b>	<b>Theory &amp; Purpose</b>	<b>Method</b>	<b>Data analysis</b>	<b>Main findings</b>	<b>Effectiveness criteria</b>
Purcell (2012)	Audit committee effectiveness in Victorian Local Government	<p>Theory: McKinsey 7S Theory and Grounded Theory</p> <p>Purpose: Determine if audit committees in Victorian Local Government are functioning effectively and whether investigations into maladministration enhance governance and audit committee effectiveness.</p>	Qualitative and Quantitative (Mixed methods).	Results of questionnaire compared with perceptions of representative bodies of local government.	<p>Support from mayors' chief executives and chairs of audit committees that audit committees are effective.</p> <p>No support that investigations into maladministration enhance governance and audit committee effectiveness.</p>	Inputs of AC including charter, skills, activities, communications and induction and training; behavioural nuances including rigour of debate trust and effective communication and relationships.
Strickland (2011)	Initial evidence on the association between municipal audit committees, governance,	<p>Theory: Not specified</p> <p>Purpose: Study association between:</p> <ul style="list-style-type: none"> <li>- presence of municipal AC and significant deficiencies in internal control.</li> </ul>	<p>Quantitative.</p> <p>Five years 2003-2007.</p> <p>Monkeysurvey.</p> <p>Eight states with similar reporting requirements.</p>	Longitudinal analysis	Reported internal control weaknesses positively associated with the presence of an audit committee.	<p>Indicated in future research:</p> <ul style="list-style-type: none"> <li>- Qualified audit opinion</li> <li>- Experience and expertise of AC members</li> </ul>

Ref	Title	Theory & Purpose	Method	Data analysis	Main findings	Effectiveness criteria
	and internal controls.	<ul style="list-style-type: none"> <li>- presence of municipal AC and form of governance</li> <li>- presence of municipal audit committee and material weaknesses in internal controls.</li> </ul>	Limitation: Not a study of causation.			- Appointment process (fair and impartial).
Fink (2008)	Municipal Accountability: Should regulations similar to the Sarbanes-Oxley Act apply to the Local Sector	<p>Theory: General theory of innovation diffusion.</p> <p>Purpose:</p> <ul style="list-style-type: none"> <li>- Determine the willingness of municipal finance officers to accept required adoption of Principal Officer Certification (PCO) and Independent Audit Committees (IAC).</li> </ul> <p>(Other 3 purposes not relevant for this research)</p>	<ul style="list-style-type: none"> <li>- Municipalities identified through data of Census Bureau.</li> <li>- Mail survey</li> <li>- Post- survey elite electronic interview</li> </ul>	Descriptive statistics, exploratory factor analysis, multiple regression, and logistic regression.	CFO's supported POC and opposed IAC.	Study did not measure or research effectiveness.



Ref	Title	Theory & Purpose	Method	Data analysis	Main findings	Effectiveness criteria
Van der Nest (2006)	Audit committees in the South African Public Service.	<p>Purpose: Investigate audit committees in the South African public service and how effective the audit committees are in assisting accounting officers of government departments in discharging their responsibilities.</p> <ul style="list-style-type: none"> <li>- Investigate the effectiveness of support from the audit committee to the internal audit function and the Office of the Auditor-General.</li> <li>- Investigate the extent of compliance of South African public service audit committees with current best-practice recommendations.</li> </ul>	<p>Qualitative</p> <p>Semi-structured interviews with senior staff members</p> <p>AGSA, CFOs and Director-Generals of departments.</p> <p>Quantitative data collected through questionnaires distributed to chief audit executives and ACC.</p>	<p><b>Calculation of percentage compliance with best practice.</b></p> <p>Lykert-type scale to obtain responses.</p> <p>Ares tested included:</p> <p>Risk management, financial reporting, internal control, corporate governance, and external audit.</p>	<p>The majority of audit committees in the SA public service comply with legal requirements and best practice regarding the suggested functions of committees. The committee can still improve their effectiveness in their performance of certain key functions in the areas of oversight over risk management, financial reporting, and support for external audit.</p>	<ul style="list-style-type: none"> <li>- Review of risk monitoring</li> <li>- Oversight of financial reporting and compliance</li> <li>- Internal control environment/Internal audit review</li> <li>- Corporate governance oversight</li> <li>- Perceived effectiveness of support to Auditor-General.</li> </ul>

**SUMMARY OF POST GRADUATE RESEARCH ON AUDIT COMMITTEES IN THE PRIVATE SECTOR**

<b>Ref</b>	<b>Title</b>	<b>Theory &amp; Purpose</b>	<b>Method</b>	<b>Data analysis</b>	<b>Main findings</b>	<b>Effectiveness criteria</b>
Seawright (2015)	The association between audit committee directors' political skill and audit committee quality and effectiveness.	<p>Purpose:</p> <p>Develop arguments why differences in the behaviour of the audit committee due to the presence of audit committee directors' political skill can be expected.</p> <p>Theory: Agency and resource dependency.</p>	Multivariate OLS regression.	Multivariate	Significant evidence that ACs with at least one politically skilled AC director are more likely to meet regularly (be more diligent).	Audit committee meeting frequency
Reidenbach (2013)	Incentives for the Audit Committee to signal their monitoring activities using voluntary disclosure in	<p>Theory: Agency and Signaling.</p> <p>Purpose: Determine if audit committees signal their level of monitoring of the company's management and auditors</p>	Manual coding to develop voluntary disclosure measure by using unweighted index of disclosures.	Voluntary disclosure in AC reports. Automated year-on-year document	<p>Audit committees with financial expertise particularly accounting experience has a significant association with audit committee report disclosure.</p> <p>Statistically significant association between total and type of compensation paid to</p>	Incentives to provide voluntary disclosure relate to financial expertise, reputation, and compensation

Ref	Title	Theory & Purpose	Method	Data analysis	Main findings	Effectiveness criteria
	the audit committee report.	to shareholders using the audit committee report.	Focus on companies in computer services industries.	Multiple regression analyses.	the audit committee chair and reduced voluntary disclosure in the audit committee report.	
Mohamed (2011)	The effects of audit committee and internal audit attributes on internal audit quality and audit fees.	<p>Theory: Agency, Complementary and Substitution.</p> <p>Purpose:</p> <p>Examine the effects of internal audit and audit committee attributes on the quality of internal audit.</p> <p>Second purpose not relevant for this study.</p>	Quantitative Malaysian survey data via three sources: internal audit responses, external audit responses and publicly available information.	Multivariate analysis	Study finds support for positive relationship between the characteristics of the audit committee (independence, frequency of private meetings with CAE and separation of Risk Management Committee from audit committee) quality of the Internal Audit Function.	Study not on effectiveness of audit committee but the effect of audit committee on internal audit. Characteristics of audit committee included independence, frequency of private meetings with CAE, and separation of Risk Management Committee and audit committee.

Ref	Title	Theory & Purpose	Method	Data analysis	Main findings	Effectiveness criteria
Singhvi (2011)	Audit Committee Director Turnover.	Purpose: Examine the stock market reactions to disclosures of audit committee appointments and departures and changes in audit committee composition in last decade.	Quantitative. Studied cumulative abnormal return using a 3-day and 5-day window period for market reaction on appointments and departures in the post SOX period.	Statistical analysis.	Overall market reaction to appointment of directors was not significant.	Study did not focus on effectiveness but market reaction to appointments and departures.
Gabre (2008)	An empirical investigation of audit committee decision quality.	Theory: Escalation of commitment and Groupthink.  Purpose: Assess the decision quality of audit committee members as affected by two behavioural biases,	Field experiment, utilising a 2x3x2 factorial design.	Analysis of mail data.	No significant mean difference between audit committee with hiring responsibility versus not.  No significant mean difference between audit committee member who vote to retain or replace the EA if group consensus were to	Study not on effectiveness but decision quality based on escalation of commitment and groupthink.

Ref	Title	Theory & Purpose	Method	Data analysis	Main findings	Effectiveness criteria
		escalation of commitment and groupthink.			retain or replace the EA compared to if the opinions of the peers were unknown.  AC members that do not have the responsibility to hire the auditor use group consensus as a benchmark to arrive at their decision. This result is troubling.	
Marx (2008)	An analysis of the development, status and functioning of audit committees at large listed companies in South Africa.	Theory: Not indicated  Purpose: Analyse the effective functioning of audit committees in the modern business environment. Investigate the factors and events that impact on the development, status, and effective functioning of audit committees at large	Qualitative.  Inspection of annual reports and through questionnaires to CFOs and chairs for completion.		Found audit committees are well established, properly constituted and have the authority and resources to effectively discharge their responsibilities. They consist of members who act independently and who have the right mix of appropriate experience, financial literacy, and financial expertise among their members. The role of the audit committee was well	Constitution, authority, resources, independence, mix of experience, financial literacy, and financial experience.

Ref	Title	Theory & Purpose	Method	Data analysis	Main findings	Effectiveness criteria
		listed companies in South Africa.			understood and supported by the board and Chief Financial Officers.	
Persellin (2008)	An experimental analysis of the factors impacting audit committee members' judgments and decisions.	Theory: Agency  Purpose: Examine the fundamental conflicting incentives/pressures faced by audit committee members when attempting to effectively fulfil their governance responsibilities.	Two experiments using a hypothetical audit case using Executive MBA students and actual audit committee members.	Regression model	While option compensation may create misaligned loyalties when disputes between the auditor and management occurs the loyalties can be re-aligned by putting measures such as PCAOB inspections in place.	Not applicable
Zheng (2008)	Analysis of relationship between AC multiple directorship and financial reporting quality.	Purpose: Examine the corporate governance consequence of multiple directorships of members of AC of a company's board of directors specifically related to financial reporting quality.	Sample of 3169 firm-years of non-financial S&P 500 firms between 1997-2005.			Multiple directorship

Ref	Title	Theory & Purpose	Method	Data analysis	Main findings	Effectiveness criteria
Chien (2007)	The Audit Committee, internal controls, and financial distress of U.S. Public Hospitals.	Purpose: Research the relationship between presence of quality audit committees, internal control quality and corresponding financial distress.	Quantitative	Analysed audit reports on internal control over financial reporting and Federal grants for 180 individual hospitals and 700 clinics operating in the US.	The audit committee characteristics of independence, financial expertise, and increased activity level (meeting frequency) positively correlate with reduced frequencies of control problems and financial distress.	Independence, financial expertise Increased activity level (meeting frequency).
Goh (2007)	Internal Control Failures and Corporate Governance Structures – A Post Sarbanes-Oxley Act	Theory: Agency  Purpose: Investigate the link between internal control quality and governance structures.  Examine the reputation benefits faced by top management, audit committee members and	Used sample firms in study by Doyle et al. to identify firms that disclose MW from August 2003 to December 2004. Matched to control sample and relation	Used Compliance week <i>Audit Analytics</i>  Used logistic regression model to test the relation between the effectiveness of the audit	Firms with lower AC financial expertise, smaller AC and lower Board independence are more likely to have MW.  MW firms have significantly higher turnover of AC members and outside directors and lose more of these members than the control firms.	Independence  Financial expertise  Size  Diligence



Ref	Title	Theory & Purpose	Method	Data analysis	Main findings	Effectiveness criteria
	(SOX) Analysis.	independent directors for firms that report MW.	measured through logistic regression model.	committee and board, and the incidence of material weaknesses.	The extent of reputational penalties increase with the severity of the MW detected.  Results indicate MW firms experienced greater improvement in governance structures.	
Weiss (2005)	Audit committee characteristics and monitoring effectiveness.	Theory: Agency  Purpose: Provide evidence of a set of optimal AC characteristics that would satisfy SOX requirements.	Survey of AC directors and corporate secretaries for pre-Sarbanes-Oxley.  Prior empirical literature.  227 firms analysed	Monitoring effectiveness measured by manager's discretionary accrual choices as a measure of earnings quality.	Results provided evidence that an independent AC requires firm specific knowledge. In some cases, firms provided support in the form of training that improved effectiveness. Effectiveness was also improved through sufficiency of information.	Independence.  Financial expertise.  Firm provided support of A.  Degree of AC oversight.
Mustafa (2003)	Misappropriation of assets: A test of SAS	Theory: Agency  Purpose: Examine relationships between risk	Quantitative.  81 random-control and 81	One of five research questions	For companies that experienced misappropriation of assets the percentage of	Number of meetings held during the year.

Ref	Title	Theory & Purpose	Method	Data analysis	Main findings	Effectiveness criteria
	No. 82 risk factors	factors and misappropriation of assets by employees using logit models.	match-control companies investigated selected from articles reporting on misappropriation .	related to effectiveness of audit.	independent audit committee members (iacm) were significantly lower and the tenure was significantly shorter.  The number of audit committee meetings was not significant.	Percentage of independent members in AC.  Average tenure of independent AC.
Wayne (2003)	An investigation of the determinants of audit committee effectiveness.	Theory: Agency and Institutional Theory.  Purpose: Identify determinants of effective ACs.	Qualitative  12 semi-structured interviews with audit committee members.	Four worldviews of audit committee identified.	Interviewees perceive the AC has few resources including an apparent lack of expertise to fulfil their role. With the result AC must trust un-cooperative management and conflicted auditors to monitor and control the financial reporting function.	Not applicable
Jenkins 2002	Auditor independence, audit committee effectiveness,	Purpose: Examine the combined effects of audit committee effectiveness	Quantitative  Multivariate regression analysis	Analyse if more or less earnings management is mitigated	Effective audit committees mitigate income- increasing earnings management	Financial literacy  Number of meetings

Ref	Title	Theory & Purpose	Method	Data analysis	Main findings	Effectiveness criteria
	and earnings management.	and auditor independence on earnings management.		with monitoring by AC and EA.		Size of the audit committee.  Percentage of outsiders on the audit committee.
Giles (1998)	Evidence of the relation between audit committee characteristics and the Quality of financial reporting.	Theory: Agency  Purpose: Investigate if there is relationship between collective professional characteristics (competence, motivation, and time availability) of audit committee members and rating of quality of financial reporting.	Company proxy statements of 100 firms used to identify AC members and obtain work histories. Further biographical data obtained from databases, books, and other sources.	Multiple statistical methods (MANOVA, non-parametric statistics, logistic regression, and OLS).	No significant relationship between higher levels of competence, motivation, and time available and higher quality financial reporting. The findings do suggest firms with higher quality financial reporting have audit committees with more experienced members either as Chief Executive Officer or as a board member elsewhere.	Competence, motivation, and time availability
Park (1998)	Audit committees, corporate governance,	Theory: Agency  Purpose: Investigate if differences in client firms'	Quantitative	Multivariate logistic analysis	Auditor-litigated firms have weak and ineffective audit committee characteristics and internal governance	Independence  Personal financial stake in firm

Ref	Title	Theory & Purpose	Method	Data analysis	Main findings	Effectiveness criteria
	and the quality of financial reporting: Evidence from auditor litigation and market reactions to earnings announcements.	audit committee characteristics and internal governance structures contribute to the incidence of litigation against external auditors.			structures. Compared to control firms the audit committees of auditor-litigated firms have less independent outside directors, shorter tenure on boards and meet less frequently.	Quality of directors. Tenure. Activity and diligence. Expertise and knowledge in financial reporting and auditing.

**ANNEXURE 2 – SUMMARY OF AUDIT COMMITTEE DETERMINANTS OF EFFECTIVENESS REFLECTED IN RESEARCH<sup>84</sup>**

	Composition <sup>85</sup>	Authority/ Clarity of purpose <sup>86</sup>	Resources <sup>87</sup>	Diligence <sup>88</sup>	Consultation with internal and external audit	Personality	Experience with organisation/ industry	Relationship with stakeholders <sup>89</sup>	Quality of Chair	Remuneration	Size	Tenure
Spangler & Braiotta (1990)					√				√			
Kalbers & Fogarty 1993		√	√				√					
Rittenberg & Nair (1993, 1998)		√	√	√								
Lee & Stone (1997)							√					
Giles (1998)							√					
DeZoort et al. (2002)	√	√	√	√								
West & Berman (2003)	√						√	√				

<sup>84</sup> Appointment of external audit, if identified by research has not been included because it is not relevant for the study. The external audit is conducted by the Auditor-General in local government and the audit committee has no responsibility in this regard.

<sup>85</sup> Includes characteristics like independence, objectivity, transparency, expertise, and integrity

<sup>86</sup> Includes relationship with management, audit committee charter, delegation, influence, responsibilities

<sup>87</sup> Includes timeliness and usefulness of information, working relationships, number of members, access, and support from management (presence at meetings and implementing recommendations), internal and external audit.

<sup>88</sup> Includes willingness to work and attend meetings, ask hard questions, active interest, outspoken, courageous, incentive, motivation, and perseverance.

<sup>89</sup> Includes good communication skills.

	Composition <sup>85</sup>	Authority/ Clarity of purpose <sup>86</sup>	Resources <sup>87</sup>	Diligence <sup>88</sup>	Consultation with internal and external audit	Personality	Experience with organisation/ industry	Relationship with stakeholders <sup>89</sup>	Quality of Chair	Remuneration	Size	Tenure
Abbott, Parker & Peters (2004)	√			√								
Braiotta (2004)		√	√									
Cohen et al. (2004)	√		√		√							
Purcell et al. (2004)	√	√	√	√		√						
Nashwa (2005)	√			√			√	√				
Weiss (2005)							√					
Van der Nest (2006)	√			√	√			√	√			
Chien (2007)	√			√								
Turley & Zaman (2007)		√		√				√	√			
AGA (2008)		√	√		√		√					
DeZoort (2008)							√					
Marx (2008)	√	√	√		√			√	√		√	

	Composition <sup>85</sup>	Authority/ Clarity of purpose <sup>86</sup>	Resources <sup>87</sup>	Diligence <sup>88</sup>	Consultation with internal and external audit	Personality	Experience with organisation/ industry	Relationship with stakeholders <sup>89</sup>	Quality of Chair	Remuneration	Size	Tenure
Magrane & Maltus (2010)	√	√		√			√	√		√	√	√
Zaman & Sarens (2013)								√				
IIA (2014)	√			√			√					
Purcell (2014)	√	√										



## ANNEXURE 3 – EXAMPLE OF INTRODUCTION LETTER AND INFORMED CONSENT LETTER



Dear Municipal Manager

My name is Mariaan Roos and I am a registered PhD student at the School of Public Leadership, University of Stellenbosch. I am conducting research on audit committees in local government and have selected the Western Cape and the Northern Cape as part of my sample. The title of my thesis is: **Practice, practitioners and praxis of audit committees in local government South Africa: A case study**. The supervisors for my study are Dr Len Mortimer and Professor Johan Burger.

The purpose of this study is to research the determinants of effective audit committees in local government as demonstrated by the performance of their roles and responsibilities and perceived by stakeholders. The study is qualitative in nature and to add value should include interviews. As part of the study it is required that I interview the mayor, the municipal manager, audit committee chairperson, chief financial officer, chief audit executive and the external auditor.

I hereby request your permission to use [municipality] as part of my sample. If you are in agreement could I also kindly ask you to advise the different parties about the intended study. Confidentiality and anonymity will be maintained under all circumstances. The results of the study will be made available on your request and will only be used for scholarly purposes to contribute towards the knowledge in the field. Ethical clearance for this study has already been obtained from Stellenbosch University.

I also attach the Letter of Consent that provide more information and serves to ensure the integrity of the interview process and confidentiality.

I will highly appreciate your kind and valuable assistance in this research project and are looking forward to your positive response. Please do not hesitate to contact me or any of my supervisors for this study if you need any additional information. For your use if needed, their contact details are included in the attached consent form.

In appreciation.

Warmest regards

Mariaan Roos

University of Stellenbosch



UNIVERSITEIT • STELLENBOSCH • UNIVERSITY  
jou kennisvennoot • your knowledge partner

## STELLENBOSCH UNIVERSITY

### CONSENT TO PARTICIPATE IN RESEARCH

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Dear

My name is Mariaan Roos and I am registered for a PhD degree with the University of Stellenbosch. I would like to invite you to participate in a research project entitled **Practice, practitioners and praxis of audit committees in local government South Africa: A case study**.

Please take some time to read the information presented here, which will explain the details of this project and contact me if you require further explanation or clarification of any aspect of the study. Also, your participation is **entirely voluntary** and you are free to decline to participate. If you say no, this will not affect you negatively in any way whatsoever. You are also free to withdraw from the study at any point, even if you do agree to take part.

#### 1. PURPOSE OF THE STUDY

The objective of this study is to research the determinants of effective audit committees in local government, demonstrated by the performance of their roles and responsibilities and as perceived by stakeholders. Audit committee stakeholders, for purposes of this study, refer to the mayor, the municipal manager, audit committee chairperson, chief financial officer, chief audit executive and the external auditor.

#### 2. PROCEDURES

If you volunteer to participate in this study, we would ask you to make yourself available, at a time and place convenient for you to discuss various themes related to the research. The total length of time for the discussion should not exceed two hours.

#### 3. POTENTIAL RISKS AND DISCOMFORTS

No foreseeable risks, discomforts or inconveniences to yourself are anticipated.

#### 4. POTENTIAL BENEFITS TO SUBJECTS AND/OR TO SOCIETY

There is no guarantee that you will benefit directly from the study. However, I believe the results of the research can generate knowledge that may create a framework that will improve the contribution by audit committees to corporate governance and inform solutions and recommendations for improvement and challenges experienced by audit committees in local government. The results of the study could also lead to suggestions for policy, processes and structures for audit committees in local government and a model for further use/replication to study similar research problems in other or related contexts.

#### 5. PAYMENT FOR PARTICIPATION

You will not receive any compensation for participating in this study.

## **6. CONFIDENTIALITY**

Confidentiality and anonymity will be maintained.

## **7. PARTICIPATION AND WITHDRAWAL**

You can choose whether to be in this study or not. If you volunteer to be in this study, you may withdraw at any time without consequences of any kind. You may also refuse to answer any questions you don't want to answer and still remain in the study. The investigator may withdraw you from this research if circumstances arise which warrant doing so.

## **8. IDENTIFICATION OF INVESTIGATORS**

If you have any questions or concerns about the research, please feel free to contact Dr Len Mortimer (Supervisor for the Study), School of Public Leadership, Belville Park Campus, Carl Cronje Drive, Belville; Telephone number 021 9184122; Email address: [len.mortimer@spl.sun.ac.za](mailto:len.mortimer@spl.sun.ac.za).

## **9. RIGHTS OF RESEARCH PARTICIPANTS**

You may withdraw your consent at any time and discontinue participation without penalty. You are not waiving any legal claims, rights or remedies because of your participation in this research study. If you have questions regarding your rights as a research participant, contact Ms Maléne Fouché [[mfouche@sun.ac.za](mailto:mfouche@sun.ac.za); 021 808 4622] at the Division for Research Development.

You have right to receive a copy of the Information and Consent form.

**If you are willing to participate in this study please sign the attached Declaration of Consent and hand it to the researcher before the interview.**

### DECLARATION BY PARTICIPANT

By signing below, I ..... agree to take part in a research study entitled **Practice, practitioners and praxis of audit committees in local government South Africa: A case study** and conducted by Mariaan Roos

I declare that:

- I have read the attached information leaflet and it is written in a language with which I am fluent and comfortable.
- I have had a chance to ask questions and all my questions have been adequately answered.
- I understand that taking part in this study is **voluntary** and I have not been pressurised to take part.
- I may choose to leave the study at any time and will not be penalised or prejudiced in any way.
- I may be asked to leave the study before it has finished, if the researcher feels it is in my best interests, or if I do not follow the study plan, as agreed to.
- All issues related to privacy and the confidentiality and use of the information I provide have been explained to my satisfaction.

Signed on .....

.....

**Signature of participant**

**SIGNATURE OF INVESTIGATOR**

I declare that I explained the information given in this document to \_\_\_\_\_. The participant was encouraged and given ample time to ask me any questions. This conversation was conducted in English and no translator was used.

\_\_\_\_\_  
**Signature of Investigator**

\_\_\_\_\_  
**Date**

## ANNEXURE 4– EXAMPLE OF INTERVIEW GUIDE FOR INTERVIEW WITH THE MAYOR

### INTERVIEW SCHEDULE: THE MAYOR

#### Main themes of discussion:

**Assessment of authority; Membership; Appointment; Role of audit committee; Meetings and activities; Informal practices and interactions; Reporting by AC; Value added**

#### 1. Assessment of authority

- 1.1 Are you of the view that the audit committee has the necessary authority and power to fulfil its responsibilities, and if not why not?
- 1.2 Do you think the audit committee get support from the various role-players including council, mayor and mm? Why do you say so? Please describe the support provided to the audit committee.
- 1.3 Do you think there is a difference between playing an advisory role versus an oversight role? If so, what role does the audit committee play in your opinion? Do you believe it is the appropriate role to play?
- 1.4 What resources are provided to the audit committee to fulfil its mandate? What resources are needed and why? What can be done to improve the situation?
- 1.5 Are you of the opinion that the audit committee members have sufficient time and commitment to fulfil their responsibilities?
- 1.6 Do you think the council understand the role the audit committee plays and the value it can add? Why do you say so?
- 1.7 Are you involved with the performance assessments of audit committee members or the chair?

#### 2. Membership

- 2.1 Are you satisfied with the membership of the audit committee in terms of experience, expertise, and independence? (Financial; Risk Management; IT; Performance Management). What other expertise would you say is also necessary and why?
- 2.2 How is independence of audit committee members ensured?
- 2.3 What important characteristics or attributes do you think is necessary for an effective audit committee members and why? Does the audit committee possess this?
- 2.4 How do the audit committee members demonstrate diligence and what are you looking for to measure diligence?
- 2.5 How important is the role of the audit committee chairperson? What are the specific activities the audit committee chair should be playing? Is the chair demonstrating this?

- 2.6 Are you satisfied with the current communication between the audit committee members and yourself as Mayor and council? If not why not and what can be done to improve the situation?
- 2.7 Do audit committee members undertake ongoing personal development activities to update their skills and knowledge? How is this measured?

### 3. Appointment

- 3.1 Who decides and what is the process for appointing the audit committee members and chairperson?
- 3.2 What information is provided to council during the appointment process to inform the decisions for the appointment of the audit committee members?
- 3.3 If improvements are necessary in the appointment process, where should it be and how can it be achieved in your opinion?

### 4. Role of the audit committee

- 4.1 In your opinion which of the following areas are included in the mandate of the audit committee?

Oversight of financial reporting process and AFS including accounting policies
Oversight of internal control
Oversight Internal audit
Oversight external audit
Oversight Risk management
Review of Performance management and performance information
Oversight of governance
Oversight Compliance with other legislation
Review of ethics and code of conduct
Respond to the council on any issues raised by the Auditor-General
Carry out investigations into the financial affairs of the municipality
Overview of combined assurance

- 4.2 Are you of the opinion that the audit committee supports you in your role and responsibilities as mayor and council and in what way? If improvements are necessary, where should they be made and, in your opinion, how can they be achieved?

### 5. Meetings and activities of the audit committee

- 5.1 Do you attend any of the audit committee meetings? If so?
- 5.2 Is the information presented and detail of the meetings satisfactory? What improvements would you like to recommend?
- 5.3 In your opinion do the audit committee play a ceremonial role or are there substantive oversight?

- 5.4 How important are the (interrogating) questions of the audit committee? What are typical questions the audit committee asks, and what communication style is followed? In your opinion does the audit committee encourage high quality debate with robust and probing questions and do they actively contribute at meetings? What improvements are necessary?
- 5.5 Are you of the opinion that the audit committee focus on the correct areas? If improvements are necessary, where should they be made and, in your opinion, how can they be achieved?

## **6. Informal practices and interactions**

- 6.1 Describe the nature of and frequency of informal practices and interactions between meetings, if any. What are discussed?
- 6.2 How important are informal practices and interactions and what benefits are achieved by having informal interactions?

## **7. Relationships between stakeholders**

- 7.1 How would you rate the professional relationship between the audit committee and municipal manager? Why and how can it be improved? (Frank and open)
- 7.2 How would you rate the communication between the audit committee and municipal manager. Why and how can it be improved?
- 7.3 Are you of the opinion that the audit committee audit supports the mayor and council and management in the role it has to play? Why do you say so? How can it be improved?

## **8. Reporting from the audit committee**

- 8.1 Are you satisfied with the current reports provided by the audit committee? If not why not? What can be done to improve the situation?

## **9. Overall rating of effectiveness of audit committee**

- 9.1 In your opinion does the audit committee add value to the municipality? Why do you say so? Which areas are most value added? What areas should more value be added?